FILED
Office
FEB 15

IN THE

Supreme Court of the United States

OCTOBER TERM, 1943

No. 130

BESSIE P. DOUGLAS,

Petitioner,

vs.

COMMISSIONER OF INTERNAL REVENUE.

No. 131

BESSIE P. DOUGLAS,

Petitioner,

vs.

COMMISSIONER OF INTERNAL REVENUE.

No. 132

ESTATE OF CHARLES H. ROBINSON, NORTHWESTERN NATIONAL BANK AND TRUST COMPANY OF MINNEAPOLIS, JESSIE P. ROBINSON, ET AL., ETC.,

Petitioners,

vs.

COMMISSIONER OF INTERNAL REVENUE.

No. 133

BERNICE B. DALRYMPLE,

Petitioner,

vs.

COMMISSIONER OF INTERNAL REVENUE.

ON WRITS OF CERTIORARI TO THE UNITED STATES CIRCUIT COURT OF APPEALS FOR THE EIGHTH CIRCUIT.

PETITIONERS' BRIEF

JAMES E. O'BRIEN AND
KIMBALL B. DeVOY,
Attorneys for Petitioners,
808 First National-Soo Line Building,
Minneapolis, Minnesota.

Of Counsel:
THOMAS P. HELMEY,
1100 First National-Soo Line Building,
Minneapolis, Minnesota.

Hayward Brief Co., 601-7 Fourth Ave. So., Minneapolis

INDEX

	Page
Opinions of the Courts Below	2
Grounds Upon Which Jurisdiction Is Invoked	2
Statement of the Case	2
Specifications of Error	6
Argument	8
I. Introduction	8
II. The Untaxed Royalties of Prior Years Were Capital Recoveries in Those Years Under Sections 23(m), 114(b)(1), and 113(b)(1)(B), Resulting in Permanent Reduction of Basis and Hence Cannot Be Treated as Income for Any Year or Years; Article 23(m)-10(c), Regulations 94, Is Therefore Wholly Invalid	14
III. The Untaxed Royalties Were Received In Separate Annual Installments In Each of Eight Prior Years; None Was Received in 1937; Even If They Are Income, Treating Them As If All Received In 1937 Is Not In Accord With Fact and Violates Sections 23(m), 41 and 42, Resulting In Hardship and the Practical Denial of the "Reasonable Allowance For Depletion"; Article 23(m)-10(c) Is Therefore Wholly Invalid	31
IV. Assuming This Court Should Hold the Regulation Valid, It Should Not Be Applied to Deductions Taken When the Regulation Was Not In Effect	59
V. Depletion Deductions Resulting In No Tax Reduction When Taken Should Not Be Included In Gross Income In the Year of Termination of Lease	61
VI. The Regulation Was Not Validated By Reenactment of the Revenue Acts	64
VII. The Circuit Court of Appeals Had Full Jurisdiction to Reverse the Board and Should Have Done So On the Ground That the Board's Decision Was Contrary to Law	68

CASES CITED

Barnett, Grace M. (1939), 39 B. T. A. 864 . . . 10, 32, 37, 46, 47, 49, 60, 69

Blum vs. Helvering (U. S. C. A. for D. of C.—1934), 74 F. (2d) 482 . . . 33

Boeing vs. Owsley, 122 Minn. 190 . . . 26

Bromley vs. McCaughn, 280 U. S. 124, 84 L. Ed. 226 . . . 46

Burnet vs. Harmel (1932), 287 U. S. 103, 77 L. Ed. 199 . . . 26

Burnet vs. Sanford & Brooks Co. (1931), 282 U. S. 359, 51 S. Ct. 150, 75 L. Ed. 383 . . . 32, 40, 42, 48

Burnet vs. Thompson Oil & Gas Co. (1931), 283 U. S. 301, 75 L. Ed. 1049, 51 S. Ct. 418 . . . 27, 40

Cleveland Ry. Co. vs. Commissioner, 36 F. (2d) 347 . . . 34

Commissioner vs. Gooch Milling Co. (U. S.—1943), 88 L. Ed. (Adv. Sheet No. 3) 140, 64 S. Ct. 184 . . . 31

Commissioner vs. Heininger (Dec. 20, 1943), . . . U. S. . . . , 88 L. Ed. (Adv. Sheet No. 4) 197, 64 S. Ct. 249 . . . 69

Page

Cooper, A. T. (1927), 7 B. T. A. 798; Acq., VII-1 C.B. 1 ..... 9, 10, 59, 60, 61, 64
Crabb, Delores (1939), 41 B. T. A. 686 10
Crabb vs. Commissioner (C. C. A.—5th), 119 F. (2d) 772 ..... 11, 46
Dobson vs. Commissioner (Dec. 20, 1943), ... U. S. ..., 88 L. Ed. (Adv. Sheet No. 4) 179, 64 S. Ct. 239 ..... 56, 62, 63, 68
Dobson vs. Commissioner (Sub. nom. Harwick vs. Commissioner), 133 F. (2d) 732 ..... 61, 63
Griffiths vs. Helvering (1939), 308 U. S. 355, 84 L. Ed. 319, 60 S. Ct. 277 55
Harwick vs. Commissioner (1943), 133 F. (2d) 732 61
Helvering vs. Griffiths (1943), ... U. S. ..., 87 L. Ed. (Adv. Sheet No. 10) 597, 615, ... S. Ct. 61, 67
Helvering vs. American Chicle Co. (1933), 291 U. S. 426, 78 L. Ed. 891, 54 S. Ct. 460 52
Helvering vs. Hallock (1940), ... U. S. ..., 84 L. Ed. 383 65-66
Helvering vs. American Dental Co. (1943, ... U. S. ..., 87 L. Ed. (Adv. Sheet No. 10) 574, ... S. Ct. 52
Herring vs. Commissioner (1935), 293 U. S. 322, 79 L. Ed. 389, 55 S. Ct. 179 ..... 10, 14, 15, 16, 24, 29, 30, 44, 46, 49, 50
Hull vs. Commissioner (C. C. A.—4th), 87 F. (2d) 260 33
Ilfeld, Charles, Co. vs. Hernandez (1934), 292 U. S. 62, 68, 78 L. Ed. 1127, 1131, 54 S. Ct. 596 55
Knapp, Kittie A. (1927), 7 B. T. A. 790; Acq., VII-1 C.B. 17 ..... 9, 10, 59, 60, 61, 64
Lamont, John D. (1940), B. T. A. Memo. op. Aug. 29, 1940, Docket No. 94,875, 1940 C. C. H. Decision No. 11,298-D 10, 11
Lamont vs. Commissioner (C. C. A.—8th), 120 F. (2d) 996, 998. ..... 11, 12, 32, 37, 46, 47, 55, 59
Langdon-Warren Mines, Inc., vs. Reynolds (D. C.—Minn.—1943), 52 F. Supp. (Adv. Sheet No. 6) 512; 43-3 U. S. T. C., Par. 9534 47
McCahill vs. Helvering (1935, C. C. A.—8th), 75 F. (2d) 725, 728 19
Maryland Casualty Company vs. United States, 251 U. S. 342 52
Manhattan General Equipment Co. vs. Commissioner (1936), 297 U. S. 129, 134, 80 L. Ed. 538, 56 S. Ct. 397 65
Murphy Oil Co. vs. Burnet (1932), 287 U. S. 299, 77 L. Ed. 318, 53 S. Ct. 161 ..... 10, 14, 15, 16, 24, 45, 46, 49, 50, 58, 69
Northwestern States Portland Cement Co. vs. Huston, Collector (C. C. A.—8th, 1942), 126 F. (2d) 196 ..... 31, 33, 48
Shawmut Company (1940), B. T. A. Memo. op. Aug. 29, 1940, Docket No. 96,310, 1940 C. C. H. Decision No. 11,301-G 10, 11
Shawmut vs. Commissioner (C. C. A.—8th), 120 F. (2d) 996 11
Sneed vs. Commissioner (C. C. A.—5th), 119 F. (2d) 767, 770 ..... 11, 12, 32, 37, 46, 55
Sneed, J. T., Jr. (1939), 40 B. T. A. 1140 10
Stanton vs. Baltic Mining Co. (1915), 240 U. S. 103 26
State vs. Evans, 99 Minn. 220 26
State vs. Royal Mineral Assn., 132 Minn. 232 26

Page

Stratton's Independence vs. Howbert (1913), 231 U. S. 399..... 26
Sugar Creek Coal & Mining Co. (1934), 31 B. T. A. 344..... 56
United States vs. Kirby Lbr. Co. (1931), 284 U. S. 1, 76 L. Ed. 131, 52 S. Ct. 4..... 52
United States vs. Scott & Sons, Inc. (C. C. A.—1st, 1934), 69 F. (2d) 728, 732..... 56
Virginian Hotel Corp. vs. Commissioner (1943), 319 U. S. 523, 87 L. Ed. 1149, 63 S. Ct. 1260.....24, 54, 58
Von Baumbach vs. Sargent Land Co. (1916), 242 U. S. 503..... 26
Woolworth Co., F. W. vs. United States (C. C. A.—2nd, 1937), 91 F. (2d) 973..... 65

STATUTES AND REGULATIONS CITED

Statutes:

Revenue Act of 1913, Section II(G)(b)..... 26
Revenue Act of 1916, Section 5(a)(8th)(b)..... 27
Revenue Act of 1918, Section 214(a)(10)..... 28
Revenue Act of 1926, Section 1003(b)..... 68
Revenue Act of 1934, Section 12(b)..... 62
Revenue Act of 1936, C. 690, 49 Stat. 1648:
Section 12..... 43
Section 23(m).....6, 7, 8, 15, 16, 18, 19, 20, 21, 23, 25, 26, 31, 41, 44, 49, 51, 54, 62, 63
Section 41.....7, 10, 11, 41, 42, 43, 59
Section 42.....7, 10, 11, 33, 34, 41, 42, 43, 59
Section 111(a)..... 22
Section 113(a)..... 17
Section 113(b)(1)(B).....6, 7, 11, 15, 16, 17, 22, 23, 25, 30, 49, 50, 51, 55, 58
Section 114(a)..... 17
Section 114(b)(1).....6, 7, 11, 15, 16, 17, 22, 23, 25, 30, 58
Section 293(a) and (b)..... 13
Internal Revenue Code, Section 272(g)..... 31
Internal Revenue Code, Section 1141(c)(1)..... 68
Revenue Act of 1942, Section 116; 56 Stat. 798, 812, C. 619; 26 U. S. C. A., 1942 Supp., Sec. 22 (now Section 22(b)(12) I. R. C.)..... 56
Internal Revenue Code, Section 22(b)(12).....56, 57, 62

Treasury Regulations:

Regulations 45 (Preliminary Ed.—1918 Act), Article 215...9, 29
Regulations 45, Article 216..... 28
Regulations 45 (1920 Ed.—1918 Act), Article 215(d).....9, 29
Regulations 62 (1921 Act), Article 215..... 9
Regulations 65 (1924 Act), Article 216..... 9
Regulations 69 (1926 Act), Article 216..... 9
Regulations 74 (1928 Act), Article 236.....9, 60, 64
Regulations 77 (1932 Act), Article 230..... 9
Regulations 86 (1934 Act), Article 23(m)-10..... 9

Page

Regulations 94:
Article 22(a)-14 52
Article 23(m)-10(b) 15, 16, 49, 50
Article 23(l)-5 54
Article 23(m)-10(c) 4, 5, 7, 8, 9, 10, 13, 19, 21, 22, 23, 25, 31, 34, 38, 40, 41, 42, 44, 45, 47, 49, 51, 58, 61, 64, 69
Article 23(m)-11 ..... 53, 55
Par. 48, p. 493 13
Article 113(b)-1 16
Regulations 101 (1938 Act), Article 23(m)-(10) 9
Regulations 103 (I. R. C., as amended by 1940 Revenue Acts), Section 19.23(m)-10 9
Regulations 111 (I. R. C., as amended by Revenue Act of 1942) Section 29.23(m)-10(c) 9, 64
Regulations 111, Section 29.22(b)(12)-1 (b)(2) 57, 62

Rulings of Commissioner:
A. R. R. 1147, I-2 C.B. 138 12
Acq. Knapp, 7 B. T. A. 790, VII-1 C.B. 17 ..... 9, 10, 59
Acq. Cooper, 7 B. T. A. 798, VII-1 C.B. 1 ..... 9, 10, 59
G. C. M.—14448, XIV-1 C.B. 98 ..... 29-30, 61
Withdrawal of Acq. XI-2 C.B. 14 and 12 ..... 10, 61

TEXT BOOKS

Brown, Robert C., Regulations, Reenactment, and the Revenue Act, 54 Harvard Law Review 377 66
Feller, A. H., Addendum to the Regulations Problem, 54 Harvard Law Review 1311 66
Finney, Principles of Accounting, Prentice Hall, Inc., 1937, Vol. 1, Intermediate, p. 379 53
Gilman, Analyzing Financial Statements, Revised Edition, Ronald Press, 1934, pp. 234-237 53
Griswold, Erwin N., A Summary of the Regulations Problem, 54 Harvard Law Review 398 66
Griswold, Erwin N., Postcriptum, 54 Harvard Law Review 1323 .. 66
Kester, Advanced Accounting, Third Revised Edition, Ronald Press, 1933, p. 571 53
Maguire & Zimet, Hobson's Choice in Federal Taxation, 48 Harvard Law Review 1281 50
Mertens, Law of Federal Income Taxation (1942), Vol. 4, Sec. 24.18, and Sec. 24.64 25
Mertens, Law of Federal Income Taxation, Vol. 2, Chap. 12, Secs. 12.50, 12.14; 12.07, 12.05, 12.06 ..... 33, 34
Montgomery, R. H., Auditing Theory and Practice, Sixth Edition, Ronald Press, 1940, p. 242 53

IN THE

Supreme Court of the United States

OCTOBER TERM, 1943

No. 130

BESSIE P. DOUGLAS,

Petitioner,

vs.

COMMISSIONER OF INTERNAL REVENUE

No. 131

BESSIE P. DOUGLAS,

Petitioner,

vs.

COMMISSIONER OF INTERNAL REVENUE

No. 132

ESTATE OF CHARLES H. ROBINSON, NORTHWESTERN NATIONAL BANK AND TRUST COMPANY OF MINNEAPOLIS, JESSIE P. ROBINSON, ET AL., ETC., *Petitioners,*

vs.

COMMISSIONER OF INTERNAL REVENUE

No. 133

BERNICE B. DALRYMPLE,

Petitioner,

vs.

COMMISSIONER OF INTERNAL REVENUE

ON WRITS OF CERTIORARI TO THE UNITED STATES CIRCUIT COURT OF APPEALS FOR THE EIGHTH CIRCUIT.

PETITIONERS' BRIEF

OPINIONS OF THE COURTS BELOW

The opinion of the Board of Tax Appeals (now the Tax Court of the United States) in all of these cases is reported in 46 B. T. A. 943 (R. 44). The Circuit Court of Appeals for the Eighth Circuit decided these cases in a single opinion which is reported at 134 F. (2d) 762 (R. 75).

GROUNDS UPON WHICH JURISDICTION IS INVOKED

The jurisdiction of this Court is invoked under Section 240(a) of the Judicial Code, as amended by the Act of February 13, 1925, 43 Stat. 938. The judgments of the United States Circuit Court of Appeals for the Eighth Circuit were entered on April 7, 1943 (R. 83, 84, 85). A consolidated petition for writs of certiorari was filed in this Court by the taxpayers, on July 1, 1943 (R. 85), and certiorari was granted by this Court on January 10, 1944 (R. 85, 86).

STATEMENT OF THE CASE

The stipulated facts (R. 36-43) in each of these cases, which cases were consolidated for hearing and decision in the Board, in the Circuit Court of Appeals, and in the petition for certiorari in this Court, together with the facts alleged and admitted in the pleadings, were adopted by the United States Board of Tax Appeals as its findings of fact (R. 45-46). Since, with respect to the major issue, the facts and principles are not materially different, we shall for brevity state the facts in the case of petitioner, Bessie P. Douglas (Nos. 130-131).[1]

[1]The estate of Charles H. Robinson (No. 132), and Bernice B. Dalrymple's (No. 133), transferor, Irene B. Robinson Cirkler, were co-owners of the mine with Mrs. Douglas (Nos. 130-131). With respect to the main issue, the facts are substantially identical except that the estate became co-owner of the land upon the death of Charles H. Robinson, Aug. 16, 1932, so that in No. 132 deductions from 1932 to 1936 are involved instead of deductions from 1929 to 1936 as in the other two appeals. The facts of Nos. 132 and 133 are briefly stated in the stipulation of fact (R. 36-43).

In and prior to 1929, Bessie P. Douglas was the owner of an undivided one-half interest[2] in an iron mine situated in Minnesota from which some ore had been removed (R. 36, 46). On July 1, 1929, she and her co-owners leased the mine to the Republic Steel Corporation for a term of 30 years, commencing on that date (R. 36, 46).

In each of the eight years from 1929 to 1936, inclusive, Bessie P. Douglas received advance minimum royalty payments (R. 37, 46). By terms of the lease[3] these payments were required to be paid by the mining company annually whether ore was extracted or not (R. 46). Advance royalties paid were to be applied to iron ore later mined and shipped (R. 46).

For each year from 1929 to 1936, Bessie P. Douglas filed her Federal income tax return on the cash basis (R. 43, 46). For each year she included in her gross income the full amount of advance royalty received by her in that year (R. 37, 46). For each year she deducted therefrom an allowance for depletion computed on the cost basis (R. 37, 46), which the Commissioner reviewed and allowed (R. 37, 46).

In 1937, the mining company rendered written notice cancelling the lease pursuant to its terms (R. 36, 46). It had mined and shipped no iron ore during the life of the lease (R. 36, 46). For the year 1937, Bessie P. Douglas filed her

---

[2]Charles H. Robinson owned an undivided one-sixth interest. His executors are petitioners in No. 132. Irene B. Robinson Cirkler owned an undivided one-sixth interest. The transferee of her estate, Bernice B. Dalrymple, is petitioner in No. 133. Adeline Morse owned the remaining interest. Her executors did not appeal from the Board.

[3]A typewritten copy of the lease and amendment thereto was attached to the Stipulation of Fact as Exhibit A.—See Par. A. 2. of Stipulation (R. 36). Because of the undue length of these documents and because it was deemed that the material provisions thereof were separately stated in the stipulation, they were omitted from the printed record in the Circuit Court of Appeals (R. 72). They were, however, a part of the record certified from the Board of Tax Appeals to the Circuit Court of Appeals (R. 71). If, for any reason, this Court may desire to see said lease as amended as an aid to the proper disposition of this case, taxpayers are willing that the same be brought before this Court in such manner and form as the Court may direct.

income tax return and did not report again as gross income for that year the untaxed portion of the royalties received and included in gross income in the prior years 1929 to 1936 (R. 37).

Upon review of her return for 1937, the Commissioner determined a deficiency based upon her failure to include in 1937 gross income sums totaling $53,299.03 (R. 14, 15, 46-47), equalling the aggregate depletion deductions of prior years, and consisting of the untaxed portions of royalty received in separate annual amounts in each of the eight years preceding 1937.[4] Accompanying this addition to 1937 income, was an upward revision of taxpayer's basis in the amount of $53,299.03 (R. 14-15). These two actions and the resultant deficiency in tax give rise to the issues of this case.

The assessed tax due to inclusion of these sums in gross income of 1937 is $26,545.30.[5] The aggregate tax reduction due to depletion deductions in the eight years prior to 1937 was $6,923.51 (Stipulation of Fact. Pars. B.9 and B.11, R. 37-38). The tax assessed for one year is $19,621.79 in excess of the total tax savings spread over eight years.

The actions of the Commissioner in (1) raising basis, and (2) allocating these amounts to 1937 gross income, were taken pursuant to Article 23(m)-10(c), Regulations 94, which provides as follows:

> "If for any reason any such mineral lease expires or terminates or is abandoned before the mineral which has been paid for in advance has been extracted and removed, the lessor shall adjust his capital account by restoring thereto the depletion deductions made in prior years on account of royalties on mineral paid for but

---

[4]Certain other adjustments to gross income were made, but the deficiency attributable to them is not in controversy here (R. 14, 15).

[5]This is simply a mathematical computation made by deducting the $53,299.03 from the net income of $100,559.14 claimed by the Commissioner to be the correct net income (R. 15), leaving $53,260.11 as the net income claimed to be correct by petitioner. Applying the 1937 rates to $53,260.11 we find the total tax liability to be $9,954.03, or $26,545.30 less than the $36,499.33 claimed by the Commissioner.

not removed, and a corresponding amount must be returned as income for the year in which the lease expires, terminates, or is abandoned."

Petitioner resisted the assessment on the grounds that the regulation was without authority of law, was in conflict with pertinent provisions of the statute, and was wholly unreasonable in practical operation and result. If the regulation is wholly invalid, as we believe it to be, the case was and should have been at an end.

If the regulation was held valid, two other issues arose involving the applicability of the regulation (1) to depletion deductions in prior years which resulted in no reduction in petitioner's tax, and (2) to all deductions prior to 1932 which were taken by petitioners in years when Article 23(m)-10(c) had been declared invalid by two decisions of the Board of Tax Appeals and was revoked by the Commissioner's published acquiescence in these decisions.

The Board of Tax Appeals held the regulation valid as to all deductions except the deduction taken by Mrs. Douglas in 1933, which resulted in no offset of income and in no reduction in tax (R. 53). It distinguished the Douglas deduction of 1934 and the Robinson (No. 132) deduction of 1932, portions of each of which resulted in no reduction of tax but did result in offset of income (R. 50-53).

Taxpayers appealed from the decision of the Board holding the regulation valid as to any of the prior deductions. The Commissioner appealed in the Douglas case from that portion of the Board's decision which held the regulation invalid as applied to non-tax-saving deductions of prior years.

The cases were consolidated before the Circuit Court of Appeals for the Eighth Circuit and on April 7, 1943, that court entered the following decision (R. 75—134 F. (2d) 762):

As to the appeals taken by the taxpayers, the Court affirmed the decision of the Board, holding that an amount equal to the prior depletion deductions constituted income in 1937 (R. 76-81).

As to the appeal taken by the Commissioner, the Court reversed the decision of the Board, asserting that the fact that the depletion deducted in prior years effected no reduction in taxable income, did not render the regulation invalid as applied to such non-tax-saving deduction (R. 81-82).

Taxpayers filed petitions for certiorari in this Court on July 1, 1943 (R. 86), which were granted on January 10, 1944 (R. 85, 86).

SPECIFICATIONS OF ERROR

I.

In holding that, under the Revenue Act, it is within the power of the Commissioner of Internal Revenue, by regulation, to adjust taxpayer's basis upwards by the amounts of the depletion deductions taken from 1929 to 1936 and to require the inclusion of corresponding amounts in the gross income of the year in which a mining lease terminated (1937), without production, the Circuit Court of Appeals erred in that the amounts of royalty received in prior years allocated to depletion by Section 23(m), cannot be taxed as income because they were capital recoveries in those prior years, under Sections 23(m), 114(b)(1) and 113(b)(1)(B), resulting in permanent reduction of basis, and, hence, cannot be treated as income for any year or years.

II.

In holding that any of the amounts equal to depletion deductions taken from 1929 to 1936 constitute taxable income for 1937, the Circuit Court of Appeals erred in that the untaxed royalties were received in separate annual installments in each of eight prior years; none was received in 1937; even if they are income, treating them as if all received in 1937, is not in accord with fact and violates Sections 23(m), 41 and 42, Revenue Act of 1936, resulting in hardship and the practical denial of the "reasonable allowance for depletion"; even if such amounts can be treated as 1937 income by reason of Article 23(m)-10(c), Regulations 94, the deductions of 1929, 1930 and 1931 cannot be so treated because the regulation was revoked when such deductions were taken.

III.

In holding that amounts equal to depletion deductions of prior years which produced no tax benefit must be included in gross income in the year of cancellation of the lease, the Circuit Court erred in that the amounts of royalty received equal to such depletion deductions were allocated to capital under Sections 23(m), 114(b)(1) and 113(b)(1)(B) in such prior years, and there is nothing in the statute or in the events of the taxable year 1937 or of prior years justifying or requiring a change in the status of such amounts from capital to income, nor was there any recovery in 1937.

ARGUMENT

I. Introduction.

The two central facts upon which the decision of this case rests are (1) there is no specific statutory authorization for Article 23(m)-10(c),[6] and (2) there are statutory provisions specifically forbidding the acts done pursuant to Article 23(m)-10(c). There is a specific statutory mandate to give the taxpayer a "reasonable allowance for depletion." Such reasonable allowance is "in all cases to be made under rules and regulations to be prescribed by the Commissioner." Section 23(m), Revenue Act of 1936.[7]

As a part of the regulations thus authorized, the Commissioner promulgated Article 23(m)-10(c). Upon the termination of a mining lease, where no ore is mined, the Commissioner claims to have authority to do two things: (1) Raise the taxpayer's basis from its depleted level by the amount of the aggregate depletion deducted in prior years; (2) Assign a corresponding amount to the income of the single year of termination.

We assert that the authority for either of these acts is totally lacking in the statute, and that doing either of these acts conflicts with specific statutory provisions. By thus violating the statute, the Commissioner inflicts a totally unjustified penalty on the taxpayer. And this inequitable result is the result which the statutory provisions, to be hereinafter discussed, were designed to prevent.

If we are right on either of our main points we are entitled to full relief. Even if we are wrong on both of our main points, two other factors entitle us to partial relief.

---

[6]Article 23(m)-10(c) of Regulations 94, under the Revenue Act of 1936. To avoid needless repetition, citation of this article of the Regulations will refer to Regulations 94 unless the context indicates otherwise.

[7]The Revenue Act of 1936, as amended, is the statute applicable to this case. Hereinafter all statutory citations will be the Revenue Act of 1936 unless otherwise stated.

Thus, even if Article 23(m)-10(c) be held valid (which we do not for a moment concede), partial relief should be granted because:

1. Article 23(m)-10(c) was revoked during 1929, 1930 and 1931, when these taxpayers took their deductions for depletion. The Board of Tax Appeals had held the regulation invalid and the Commissioner had acquiesced. He withdrew acquiescence in 1932.
2. One of the deductions effected no tax reduction in the year when taken. Portions of two other deductions effected no saving when taken.

Article 23(m)-10(c) first crept into the regulations as Article 215 of Regulations 45 (Preliminary Edition), promulgated April 17, 1919, under the 1918 Revenue Act.[8] After promulgation, the forerunners of Article 23(m)-10(c) of Regulations 94 went to sleep until they were attacked in 1927 in the *Knapp* and *Cooper* cases.

Kittie A. Knapp (1927), 7 B. T. A. 790; Acq., VII-1 C. B. 17.

A. T. Cooper (1927), 7 B. T. A. 798; Acq., VII-1 C. B. 1.

In no uncertain language the Board of Tax Appeals held Article 215(d) of Regulations 45 (1920 Edition) beyond the power of the Commissioner.

> "In our view of the case the action of the respondent in requiring the inclusion in income for 1919 of any part of the difference between the depletion deductions allowed in prior years and the actual depletion sustained in those years, is without authority of law, and the regulations permitting or requiring such procedure are to that extent invalid."
>
> *Kittie A. Knapp* (1927), 7 B. T. A. 790, 792.

[8]Note: There have been changes in wording of this Regulation but the substance has remained intact throughout. Corresponding provision of all subsequent Regulations are as follows: Sec. 29.23(m)-10, Reg. 111 (1943); Section 19.23(m)-10 of Reg. 103 (1940), as amended by T.D. 4968, 1940-1 C.B. 43; and T.D. 5210, 1943-2-11316; Art. 23(m)-10 of Reg. 101 (1938), as amended by T.D. 4960, 1940-1 C.B. 28, Reg. 94 (1936) and Reg. 86 (1934); Art. 230 of Reg. 77 (1932); Art. 236 of Reg. 74 (1928); Art. 216 of Reg. 69 (1926) and Reg. 65 (1924), as amended by T.D. 3938, V-2 C.B. 117, and Art. 215 of Reg. 62 (1921) and Reg. 45, as amended by T.D. 3107, 4 C.B. 196, and T.D. 3938, V-2 C.B. 117.

In these decisions the Commissioner acquiesced. Acq., VII-1 C. B. 17; Acq., VII-1 C. B. 1.

Thus, it was thought the regulation was dead. But along came the case of *Murphy Oil Co. vs. Burnet* (1932), 287 U. S. 299, 77 L. Ed. 318, 53 S. Ct. 161 (wherein the point was not in issue) and, on the basis of a reference in the opinion to the regulation,[9] the Commissioner, in 1932, again pulled the regulation out of the hat by withdrawing acquiescence in the *Knapp* and *Cooper* cases. XI-2 C. B. 14; XI-2 C. B. 12.

Then, in the case of *Herring vs. Commissioner* (1935), 293 U. S. 322, 79 L. Ed. 389, 55 S. Ct. 179, the Supreme Court made it clear that the *Murphy Oil Co.* opinion was not a holding on the validity of Article 23(m)-10(c):

> "As to income tax liability in the year of termination of the lease, on account of bonus paid at the execution of the lease, if no mineral has then been extracted, we express no opinion."
>
> *Herring vs. Commissioner* (1935), 293 U. S. 322, 328, 79 L. Ed. 389, 393, 55 S. Ct. 179.

So the question rested until the regulation came before the Board of Tax Appeals in *Grace M. Barnett* (1939), 39 B. T. A. 864. The Board, believing the Supreme Court had held the regulation valid in the *Murphy Oil Co.* case, reversed itself and held the regulation valid on facts which did not disclose the glaring inequities lurking in it.[10]

In quick succession came the *Sneed, Crabb* and *Lamont* and *Shawmut Company* cases before the Board and the taxpayers fell before the precedent established by the *Barnett* case.

J. T. Sneed, Jr. (1939), 40 B. T. A. 1140.

Delores Crabb (1939), 41 B. T. A. 686.

---

[9]Pp. 304, 306 of 287 U. S.; pp. 323, 324 of 77 L. Ed.

[10]The *Barnett* case involved only the transfer of untaxed bonus received in 1934 to the income of 1935. No cumulation of many years' income was involved. A violation of the statute resulted (Secs. 41 and 42) but no penal effect was shown to have been caused.

John D. Lamont (1940), B. T. A. Memo. Op. Aug. 29, 1940, Docket No. 94,875, 1940 C. C. H. Decision No. 11,298-D.

Shawmut Company (1940), B. T. A. Memo. Op. Aug. 29, 1940, Docket No. 96,310, 1940 C. C. H. Decision No. 11,301-G.

Undeterred, those four taxpayers went up to their respective Circuit Courts of Appeal and were subsequently denied relief in two sets of companion cases. *Lamont* and *Shawmut vs. Commissioner* (C. C. A.—8th), 120 F. (2d) 996; *Sneed vs. Commissioner* (C. C. A.—5th), 119 F. (2d) 767; *Crabb vs. Commissioner* (C. C. A.—5th), 119 F. (2d) 772. Apparently, neither court was fully advised of the basis provisions in the statute which were involved.[11] Both courts stated that the result was substantial justice.

But in the background was the case of the instant taxpayer, Mrs. Douglas. It came on for hearing before the Board on June 16, 1941, shortly after the Fifth Circuit decided the *Sneed* case (May 5, 1941) and shortly before the Eighth Circuit decided the *Lamont* case (June 24, 1941). The Board decision in the *Douglas* case was rendered April 14, 1942. It was based solely on precedent.

The *Douglas* case then went to the Circuit Court of Appeals in March, 1943, confronted with the nine-month-old *Lamont* case. The Court thereupon abandoned its argument that past tax benefit was the basic justification for sustaining the regulation (*Lamont vs. Commissioner,* 120 F. (2d) 996, 997-998), holding the regulation valid even as to deductions resulting in no tax benefit, and thus reversing the Board on this issue (R. 81-82). Confronted with Sections 41 and 42 of the Revenue Act, the Court abandoned its

[11]The Fifth Circuit made no reference to Section 114 (b) (1) in the Sneed case. It was advised of the bearing of Section 113(b)(1)(B) but dismissed it with the observation that no sale was involved. 119 F. (2d) 767, 772.

theory of "income-then-income-now" (*Lamont vs. Commissioner*, 120 F. (2d) 996, 998) and adopted the new theory of "capital-come-income" (R. 79, 80).

The *Douglas* case comes to this Court as a *de novo* question here. It presents the problem of what, if anything, must be done under the Revenue Act to the lessor when, after years of allowable depletion deductions against advance payments, a mining lease is cancelled by the operator and no ore has been extracted.

There are, as we see them, three possible alternatives which might have been chosen:

1. Continue to treat all past untaxed royalty as recovery of capital. Leave taxpayer's basis reduced to that extent. Make no adjustment to either capital or income upon lease termination. Let matters work themselves out in future taxable years through reduced deductions for depletion in event of future lease, through reduced basis deductible in event of future sale or abandonment.

   This we believe to be the plan enacted by the Revenue Act as we will later show. This is undoubtedly the fairest and most reasonable solution for both taxpayer and government and, in the end, fully squares accounts.

2. If the Revenue Act did not, as we contend, adopt the above solution, a regulation could require an increase in basis in the year of lease termination. Past untaxed royalty would then be reclassified from capital to income. The income would be taxable for the separate years in which received. Recomputation of tax liability would be in order for each prior year.[12] Taxpayer would pay to government the precise amount of tax saved in prior years.

---

[12]This is not administratively difficult as suggested by the Fifth Circuit in *Sneed vs. Commissioner* (C. C. A.—5th), 119 F. (2d) 767, 770, 772. Witness our stipulation of fact (R. 42, 44, 46). "That would be most logical and accurate." *Sneed vs. Commissioner*, *supra*, p. 770. Further, this is precisely what the Commissioner would do if *clearly unlawful* depletion deductions were taken. A. R. R. 1147, I-2 C. B. 138.

Government and taxpayer are each restored to former position. Limitation statutes could be made inapplicable by conditioning the allowance in the first instance upon a waiver. If the basis provisions of statute did not prevent it, a regulation involving this plan would be reasonable, practical and workable. Though involving some injustice to taxpayer it would not be harsh. This would square accounts.

3. Adopt Article 23(m)-10(c). Raise taxpayer's basis. Include the "corresponding amount" in income of the year of lease termination. Cumulate all prior untaxed royalty and tax it as if all received in the year of termination.

   This was the Commissioner's solution. It is the most unfair and unreasonable of the three. In the average case it will result as it did here in extreme hardship for the taxpayer. This squares accounts and then for no reason exacts severe penalties worse than those prescribed for failure to file return, negligence or fraud. (See par. 48, p. 493, Reg. 94; Sec. 293(a) and (b), Revenue Act of 1936.) If the limitation statutes prevent the establishment of solution 2 above, they must apply with equal force here where they are, in effect, evaded by treating as income for 1937 income for 1929.

In our view of the case, the first solution is prescribed by statute covering just such contingency as here exists. It does not violate any part of the statute. The second solution involves violation of the basis provisions of the statute but might, were it not for such violation, be workable if adopted by regulation. The third solution violates the statute, is unreasonable, and is thoroughly in conflict with the fundamental spirit of the Revenue Law.

The basic issue for this case is to decide whether the regulation adopted by the Commissioner results in a "reasonable allowance for depletion" as prescribed by the Act, Section 23(m), and does not violate any other provisions of law. In our opinion, Article 23(m)-10(c) is both unreasonable and in conflict with statute, and therefore wholly invalid.

II. The Untaxed Royalties of Prior Years Were Capital Recoveries in Those Years Under Sections 23(m), 114(b)(1) and 113(b)(1)(B), Resulting in Permanent Reduction of Basis and Hence Cannot Be Treated as Income for Any Year or Years; Article 23(m)-10(c), Regulations 94, Is Therefore Wholly Invalid.

The Commissioner's case is built upon the fact that no ore was mined within the lease (R. 36, 46, 50). By reason of that fact he claims to have the authority to raise our capital account (basis) to its undepleted level of 1929, and by regulation to assign a corresponding amount to income of 1937.

In *Murphy Oil Co. vs. Burnet* (1932), 287 U. S. 299, 77 L. Ed. 318, 53 S. Ct. 161, this Court held that the receipt of an advance payment constituted at least a partial return of capital and hence was subject to depletion at least where later followed by production. Taxpayer there tried to treat all advance payments as income and to use his undepleted basis against royalties derived from actual extraction. The holding of the case is that depletion must be taken, if at all, in the taxable years when advance payments are received.

This holding was extended in *Herring vs. Commissioner* (1935), 293 U. S. 322, 79 L. Ed. 389, 55 S. Ct. 179, to require the allowance to be taken out of income in a taxable year when no production occurred and when there was no imminent production assured. The Court stated at pages 327-328 of 293 U. S.:

> "To condition the allowance on actual production, however small, or the imminent probability of production, and to deal in refinements as to the degree of probability of future production is in many cases to deny any deduction where the taxpayer elects to compute it under 204(c)(2) (flat percentage of gross income from the property) and permit it where he elects to compute it under 204(c) (on the basis of cost). But the nature and the purpose of the allowance is the same

in both cases, and we find neither statutory authority nor logical justification for withholding it in the one and granting it in the other; much less for making the decision turn upon the circumstance that no production is obtained within the year in which the bonus is paid."

The instant cases involve the logical extension of these two decisions to a case where advance payments are received and no production occurs within the lease under which such payments are received.[13] There is what we believe to be conclusive statutory support for such extension. It lies chiefly in the fact that Section 114(b)(1), relating to basis for depletion, and Section 113(b)(1)(B), relating to basis for determining gain or loss on sale, automatically and *unconditionally* reduce taxpayer's recoverable capital investment annually by the amount allowed but in no case less than the amount allowable. This annual reduction of remaining recoverable investment (adjusted basis) causes a statutory depletion in lieu of actual physical depletion of the mineral body. Thus, although the *allowance* of the deduction in the first instance, in the case of advance payments, is based upon anticipated future production, the *permanence* of the deduction is based upon a permanent reduction of basis.

The "reasonable allowance" against advance payments is granted by statute.

Section 23(m).

Article 23(m)-10(b), Reg. 94.

Murphy Oil Co. vs. Burnet (1932), 287 U. S. 299, 77 L. Ed. 318, 53 S. Ct. 161.

Herring vs. Commissioner (1935), 293 U. S. 322, 79 L. Ed. 389, 55 S. Ct. 179.

The deduction must be taken, if at all, in the years when

[13]It should be noted that, although the termination of a lease is a serious economic blow to the property, such termination, in the case of a proven mine, does not destroy anticipation of future production.

the advance payments are received. Taxpayer cannot postpone it to the day of actual extraction.

Article 23(m)-10(b), Reg. 94.

Murphy Oil Co. vs. Burnet (1932), 287 U. S. 299, 77 L. Ed. 318, 53 S. Ct. 161.

Herring vs. Commissioner (1935), 293 U. S. 322, 79 L. Ed. 389, 55 S. Ct. 179. (See particularly, p. 327 of 293 U. S.)

"A taxpayer is not permitted to take advantage in a later year of his prior failure to take any depreciation allowance or of his action in taking an allowance plainly inadequate * * *." Art. 113(b)-1, Reg. 94. This statement is likewise applicable to depletion. Art. 113(b)-1, Reg. 94.[14]

Thus a statutory plan exists fully covering the instant cases. Section 23(m) provides the deduction. Sections 114(b)(1) and 113(b)(1)(B) provide the effect of taking or having the right to take the deduction. None of these sections indicates anything conditional about either the allowance or its effects. The reduction of basis takes the place of actual reduction of ore content, and fully protects government revenues in event the anticipated physical depletion does not occur. This results in certainty to both government and taxpayer and avoids the "attendant inconvenience of indefinite postponement of the allocation of the bonus to income and return of capital" which this Court held was a part of the meaning of the word "reasonable" as used in Section 23(m). *Murphy Oil Co. vs. Burnet* (1932), 287 U. S. 299, 77 L. Ed. 318, 53 S. Ct. 161.

Section 23(m) provides the deduction. Section 114(b)(1) defines the basis *for depletion* to be the same as provided by

[14]In this light the phrase "for which deduction has once been made" in Article 23(m)-10(b), Reg. 94, is a little misleading as it may be thought to indicate that taxpayers have the option to wait and take the deduction in years when ore is extracted. *Contra, Murphy Oil Co. vs. Burnet* (1932), 287 U. S. 299, 77 L. Ed. 318, 53 S. Ct. 161.

Section 113(b)(1)(B) which defines the basis *for determination of gain or loss on sale.* These are a part of the so-called "basis provisions" of the law and under them basis is defined with meticulous precision and in detail. *Sections 113(a), 113(b), and 114(a) and (b).* Considering the care with which Congress considered and prescribed the determination of basis, it is not to be lightly supposed that the Commissioner was authorized to depart from the words of the statute.

Section 114(b)(1) provides as follows:

"SEC. 114. BASIS FOR DEPRECIATION AND DEPLETION.

(a) * * *

(b) *Basis for depletion.*—

(1) GENERAL RULE.—The basis upon which depletion is to be allowed in respect of any property shall be the adjusted basis provided in section 113(b) for the purpose of determining the gain upon the sale or other disposition of such property, except as provided in paragraphs (2), (3) and (4) of this subsection. * * *"

Section 113(b)(1)(B) provides as follows:

"SEC. 113. ADJUSTED BASIS FOR DETERMINING GAIN OR LOSS.

(b) *Adjusted basis.*—The adjusted basis for determining the gain or loss from the sale or other disposition of property, whenever acquired, shall be the basis determined under subsection (a), adjusted as hereinafter provided.

(1) GENERAL RULE.—Proper adjustment in respect of the property shall in all cases be made—

(A) * * *

(B) in respect of any period since February 28, 1913, for exhaustion, wear and

> tear, obsolescence, amortization and depletion, to the extent allowed (but not less than the amount allowable) under this Act or prior income tax laws. * * *"

It is to be noted that "Proper adjustment * * * shall in *all cases* be made." "Proper adjustment" with respect to depletion is defined by statute to be a deduction from basis "to the extent allowed (but not less than the amount allowable) under this Act or prior income tax laws." Nothing indicates that the reduction of basis is not final. Indeed, the plain meaning of the statute is that *capital* shall be deemed to have been recovered by the deduction for depletion, whether taken or not, to the extent allowed and in no case less than the amount allowable.

Dovetailing into this statutory plan is the second sentence of Section 23(m) which specifically provides that *even though subsequent events prove prior deductions for depletion to have been excessive, basis for depletion shall not be raised.*[15]

> "In any case in which it is ascertained as a result of operations or of development work that the recoverable units are greater or less than the prior estimate thereof, then such prior estimate *(but not the basis for depletion)* shall be revised and the allowance under this subsection *for subsequent taxable years* shall be based upon such revised estimate. * * *" (Italics ours.)

To our minds, this is the clincher on the question of Congressional intent. Here is an expressed legislative state-

---

[15]We do not wish again to be met on this point by a government statement "Obviously the taxpayers have misread the statute" (Brief for Commissioner in the instant case before the Circuit Court of Appeals, p. 13). We do not say the quoted portion of the statute applies directly to our case. We cite it as a clear indication of Congressional intent in a case identical with ours in principle though not identical in detail. Its identity in principle is disclosed by the factual situation to which it does directly apply. We had thought that the determination of validity of a regulation involved determination of Congressional intent.

ment that basis is to remain fixed at the lower level. Past errors in allowance for depletion are to remain buried in the past.[16] Adjustment is to be made by spreading the depleted basis over the income of future taxable years.

This is how the statute applies. X, the owner of an iron mine, has a cost basis of $100,000. He takes depletion deductions on the cost basis against advance royalties for eight years from 1929 through 1936. No ore has been mined. The mine has an estimated 100,000 tons of ore in the ground. In 1937, the surface of the ground is stripped and a probable one million tons of ore is disclosed. Since X's cost remains the same, and must be spread over ten times as many units, his depletion should have been one-tenth of what it was. He has been getting ten times as much depletion deduction as he should have gotten. Nine-tenths of his depletion was allowed in those prior years on an assumption which proved in 1937 to have been false. If the Commissioner's reasoning is correct, the procedure prescribed by Article 23(m)-10(c) should be followed. X's *basis for depletion* must be restored to a higher level by adding back the excessive depletion of prior years. And a corresponding amount must be included in X's gross income for 1937, the year in which the error is discovered. X should be penalized for taking a proper deduction by cumulating his untaxed income for previous years and allocating that income to 1937, not to the year in which received.

But such is not the law. The procedure prescribed by Section 23(m) is simple, protects the Government and does not burden the taxpayer with an indefensible penalty. The

[16]Cf. "But where revision is made on account of information subsequently obtained,' the government cannot go back into the prior years and recover the excessive deductions, and neither can the taxpayer go back to the years 1929 and 1930, before the error was known, and, by obtaining deductions for those years, upset the basis for depletion as it stood in those years." *McCahill vs. Helvering* (1935, C. C. A.—8th), 75 F. (2d) 725, 728.

And "There is absolutely no authority for going back to the preceding tax years and changing the depletion allowances already deducted." *McCahill vs. Helvering* (1935, C. C. A.—8th), 75 F. (2d) 725, 728.

above quoted portion of Section 23(m) says excessive past depletion shall not be added back to the basis for depletion. The basis for depletion shall remain unchanged. The aggregate excessive past depletion cannot be added to the income of the year when the revised estimate of tonnage is made. But, depletion *for the future* shall be at a reduced rate computed by spreading the reduced basis for depletion over the greater number of tons now known to be in the ground. Note how the statute amply protects the Government's revenues by these two provisions, *i. e.*, (1) by keeping basis at a reduced level, and (2) by reducing the depletion factor for subsequent years. Under this procedure the Government gets a greater tax upon sale of the property. The lower the basis, the greater the taxable gain on sale. Likewise, it obtains a greater tax on future royalties. The lower the rate for depletion the greater the taxable portion of royalties received. Thus, the taxpayer who has enjoyed an undue benefit in the past bears the burden thereof in the future—but the burden is imposed in an orderly and sensible fashion based upon sound equitable principles.

Let us compare the cases of Bessie P. Douglas and X, the taxpayer, referred to in the above illustration. Both have taken a depletion deduction for a series of years. The allowance in each case is entirely proper and sanctioned by law. Both deductions, though proper, are based upon assumptions which appear true at the time the deduction is made, but later prove to be erroneous. Both Commissioner and taxpayer have acted for years on honest but in fact false premises. Bessie P. Douglas' deduction proved unwarranted[17] because physical exhaustion of the mine failed to materialize. X's deduction proved unwarranted because the ton-

[17] It is "unwarranted" only in the sense that the original allowance was based on anticipated production. That it is not unwarranted in the sense that ultimate production is required to make it permanent is illustrated by the statutory provisions previously referred to.

nage proved to have been underestimated. The discovery of error arises many years later. Termination of the lease without extraction of ore disclosed the error in the Douglas case. Discovery of additional tonnage without extraction of ore disclosed the error in X's case. The facts are so parallel one would never suspect the disparity in tax treatment. The statute, which expresses Congress' intent, prescribes that X shall suffer no penalty for the honest error, but he shall square accounts *in future taxable years*. The regulation, which purports to express Congress' intent, prescribes that Bessie P. Douglas shall square accounts in the year the error is discovered and in addition shall suffer a paralyzing penalty because her deduction, in the light of subsequent events, proved unjustified.

Article 23(m)-10(c) cannot really be held to interpret the statutory intent. *It clashes with the very section of the statute which it purports to interpret.* The truth is that Article 23(m)-10(c) violates the letter and spirit of Section 23(m) from which it must draw its authority. Congress has laid down in the second sentence of Section 23(m) what its concept of a "reasonable allowance for depletion" means in a case of excessive past depletion and the regulation is clearly contrary to that concept.

It is, therefore, the contention of petitioners that the deduction to which they are entitled and which they must take, if at all, in the year in which advance royalties are received, is an *absolute* deduction granted for depletion of their capital investment which, for Revenue Act purposes, had absolutely occurred and become fixed, under the Revenue Act, in the year in which the advance royalties were received. It is their contention that the depletion deduction, insofar as advance royalties or bonuses are concerned, is in no way dependent for permanence upon physical exhaustion of the property but is rather dependent upon a statutory

depletion in lieu of actual depletion. It is their contention that the statutory depletion occurs by terms of the Act each year and that each year the basis is fixed at its lower level and by express provisions of the Act[18] is placed beyond the power of the Commissioner to raise. In consequence of this, it is contrary to the Revenue Act for the Commissioner to raise the taxpayer's basis and compel the return of a "corresponding amount" as income in the year of termination. Congress has provided its own solution to the problem of depletion deductions against advance royalties by reducing the lessor's basis each year to the extent of the depletion allowable so that, after termination of the lease, gain or loss on a sale, or depletion on a new lease, must be computed upon the reduced basis. So far as the lessor's basis is concerned he has actually suffered depletion. The reduction of his basis is made a finality by the Revenue Act itself. The Commissioner of Internal Revenue cannot supplant the solution provided by Congress with a solution of his own.

Thus, if the mine lessor had sold the reversion before the lease terminated, the depletion would clearly have been absolute and tax would have been paid on the excess of the proceeds over the depleted basis. Sec. 111(a), Revenue Act of 1936. If the lease then terminates after the sale, Article 23(m)-10(c), if valid, would become applicable, and the vendor again would pay tax on the same return of capital. Clearly the vendee could not be held taxable upon prior deductions taken by the vendor.

The statute bases the allowance for depletion upon anticipated extraction of ore. Yet the statutory plan is complete and fully covers the case where a lease is subsequently terminated without extraction. The solution provided by statute is to leave things in *status quo*. Basis is not to be tampered with. No corresponding bookkeeping "credit" to in-

[18]Sections 114(b)(1) and 113(b)(1)(B).

come in the year of termination. Taxpayer is deemed to have recovered a portion of his investment and his reduced basis is all that remains to be recovered in the future years. Never will he recover more than his original basis. The plan embodied in the "reasonable allowance" part of Section 23(m) and the correlative Sections 114(b)(1) and 113(b)(1)(B), relating to reduction of basis fully covers the instant case and protects both the Government and taxpayer. There is in fact no hiatus in the statute requiring administrative regulation. Interstitial legislation will not fit where there is no interstice.

The misconception of the Treasury and of the courts below is based upon their failure to understand the nature of the deduction for depletion. The deduction is a two-edged sword. While one blade cuts down taxable income the other simultaneously cuts down taxpayer's recoverable investment. It permits the taxpayer to recover his investment out of what would otherwise be taxable income.[19] And that cutting down of remaining recoverable investment is the protection of the Government from just such contingency as occurred in this case. Thus, when Mrs. Douglas received $10,000 in royalties in 1932 it was all income constitutionally taxable. Congress granted her the right to consider $4,958.05 as recovery of capital. As such, it not only reduced her taxable income for 1932, it reduced her remaining recoverable capital by the same amount. Depletion is not comparable to

---

[19]Royalties are taxable income under the XVIth Amendment and in the absence of a statutory deduction can be fully taxed. Without any statutory deduction for depletion, taxpayers would yet be able to recover investment by a deduction of cost upon a sale or abandonment. This would, however, be only a theoretical "recovery" unless taxpayer had some income sufficient to absorb the loss on sale or abandonment in the year in which the sale or abandonment occurred. The statutory deduction is in essence a device permitting recovery of capital in advance out of income from the property. Its purpose is to correlate the recovery of investment with the receipt of income, not leaving the taxpayer to the uncertain future "recovery" through taking a loss on sale or abandonment, not taxing him in full in the years when he receives that income and has no offsetting deduction. Article 23(m)-10(c) is the direct antithesis of the spirit of the law.

other deductions such as taxes paid, business expenses, and other like deductions which do not affect capital items and which if improperly taken cause a permanent loss of revenue to the Government. Rather, it is comparable to depreciation where excessive deductions reduce the capital base, and, upon discovery of error in a subsequent year, the capital base remains *reduced* and the Government recoups by reduced allowances in the future. This procedure is aptly illustrated by *Virginian Hotel Corporation vs. Commissioner* (1943), 319 U. S. 523, 87 L. Ed. 1149, 63 S. Ct. 1260, where, we assume that had depreciation deductions in prior years reduced taxable income, both majority and minority of this Court would have been in accord. Basis would have been reduced and future depreciation would consequently be reduced.

Thus, we believe that the statutory concept of depletion is to some extent different from the concept of actual exhaustion of physical property. This is illustrated by the *Murphy Oil Co.* and *Herring* cases where income from the property received in advance of extraction was held, partly or in full, return of capital. These cases hold that the allowance, at least in the first instance, is dependent only upon a *reasonable anticipation* of production. That statutory depletion differs from actual exhaustion is further illustrated by the fact that after recovery of all investment, actual exhaustion will not give rise to further statutory depletion. The question in this case is, when an event occurs, many years after the allowance, which shows that there will be no production under a given lease, did the original allowance sufficiently differ from actual production under the lease as not to require its retroactive disallowance? Our contention is that the original allowance, though based upon reasonable anticipation of production, was so related to the taxpayer's investment in the property that there is no neces-

sity for adjustment when that reasonable anticipation fails to materialize within a given lease. In other words, for purposes of the Revenue Act, it is not nearly so important that production did not follow anticipation within the life of the lease as it is that reduction of basis coincided with the deduction for depletion.

It is this point which Mertens speaks of when he states that depletion is correlated to income and not to production. *Mertens, Law of Federal Income Taxation* (1942), Vol. 4, Section 24.18. And this is the point covered when he says, concerning Article 23(m)-10(c):

> "Obviously, there is nothing in the abandonment or the termination of the lease that gives the landowner any income. On the contrary, such action results in the elimination of the value which he believed that he had retained under the royalty provision of the lease.
>
> Judge Hutcheson has pointed out the inconsistency of this practice with the general theory of depletion, in his vigorous dissenting opinion in the Crabb case. This practice has been approved by the Board and by the courts in all cases which have reached the courts to date. Nevertheless, the theory upon which such restoration is made, is at variance with the general theory of depletion as presently developed, and the Bureau's insistence upon such restoration prevents, to that extent, the development of a complete and logical theory of depletion correlated with income derived from minerals."
>
> *Mertens, Law of Federal Income Taxation* (1942), Vol. 4, Section 24.64.

We believe that Sections 23(m), 114(b)(1) and 113(b)(1)(B) contain in legislative form that "complete and logical theory of depletion correlated with income derived from minerals." And the Bureau has no right by its "insistence upon such restoration" to prevent the statutory operation of that theory in practice. The Circuit Court erred as a matter of law in sustaining the regulation.

We are fully borne out in this analysis of the statute by

its historical development. Section 23(m) was born out of the background of the advance royalty cases in which this Court held advance royalties to be fully taxable income.

Taxpayers had contended that receipt of advance royalty payments under mining leases, not materially different from that here involved, constituted sales of ore in the ground and that they were therefore entitled to deduct their cost or investment from the proceeds and pay tax only on the excess of selling price over cost. However, the Supreme Court held that there was no sale of ore in place, that advance royalty payments were in the nature of rent, giving the mining company only a license to mine. All receipts were therefore taxable income to the lessors under the XVIth Amendment and Congress could, if it chose, tax them in their entirety.

Stratton's Independence vs. Howbert (1913), 231 U. S. 399.

Stanton vs. Baltic Mining Co. (1915), 240 U. S. 103.

Von Baumbach vs. Sargent Land Co. (1916), 242 U. S. 503.

State vs. Evans, 99 Minn. 220.

Boeing vs. Owsley, 122 Minn. 190.

State vs. Royal Mineral Ass'n, 132 Minn. 232.

See also:

Burnet vs. Harmel (1932), 287 U. S. 103, 77 L. Ed. 199.

The Revenue Act of 1913 granted a depletion allowance based solely upon production but "not to exceed 5 per centum of the gross value at the mine of the output of the year for which the computation was made." Sec. II(G)(b), Revenue Act of 1913. This was admittedly too small an allowance to permit complete recovery of the taxpayer's capital

investment. See *Burnet vs. Thompson Oil & Gas Co.* (1931), 283 U. S. 301, 75 L. Ed. 1049, 51 S. Ct. 418. It applied only to actual royalty for ore mined and shipped. Advance minimum royalties were fully taxed.

Congress came to the rescue of recipients of actual royalty on ore mined and shipped by the *Revenue Act of 1916*, Section 5(a)(8th)(b), of which provided:

> "in the case of mines a reasonable allowance for depletion thereof not to exceed the market value in the mine of the product thereof, which has been mined and sold during the year for which the return and computation are made; such reasonable allowance to be made * * * under rules and regulations to be prescribed by the Secretary of the Treasury: provided, that when the allowances authorized * * * shall equal the capital originally invested, or in the case of purchase made prior to March first, nineteen hundred and thirteen, the fair market value as of that date, no further allowance shall be made. * * *"

Here again production is the test. Depletion is synonymous with physical exhaustion. Yet, here is recognition of taxpayer's capital investment as the depletable base. Depletion is more directly tied to capital investment (basis) than to ultimate physical exhaustion because the statute provides that when that investment has been returned through depletion allowances the allowance ceases even though physical exhaustion continues.

This provision, however, left the recipients of advance royalty payments out in the cold. Their income came years in advance of their deductions. They paid taxes in full on their royalties when received. They were entitled to depletion deductions in the future when production commenced and the related income had already been taxed. The depletion deduction was useless unless they had other non-related income against which to offset the deduction. The function and purpose of the depletion allowance as finally

developed, *i. e.*, to permit the taxpayer to recover his investment out of income from the property free of income tax, was not yet enacted.

Congress completed the rescue in the *Revenue Act of 1918*, striking the requirement of actual production out of the law, thus permitting recipients of advance royalties or bonus to correlate their deductions with income:

> "In the case of mines * * * a reasonable allowance for depletion * * * according to the peculiar conditions in each case, based upon cost, including cost of development not otherwise deducted: Provided, That in the case of such properties acquired prior to March 1, 1913, the fair market value of the property (or the taxpayer's interest therein) on that date shall be taken in lieu of cost up to that date: * * * such reasonable allowance in all the above cases to be made under rules and regulations to be prescribed by the Commissioner with the approval of the Secretary * * *."
>
> Sec. 214.(a)(10), *Revenue Act of 1918.*

Here the true character of depletion under the Revenue Act, as a device to permit recovery of investment out of income from the property, became clear. Coming as it did out of the background of the advance royalty cases, it was clear that the statutory intent in striking the production requirement was to permit recovery of investment out of income from the property even where there was no production coincident with income—just a reasonable anticipation of production.

At no place in the 1918 Act did it appear that there was anything conditional about the allowance. The allocation of part of the income from the property to return of investment by Sec. 214(a)(10), and the limitation that when all capital was returned the allowance should cease, indicate an unconditional grant. See Art. 216, Reg. 45 (1918 Act).

So, in Regulations 45, issued April 17, 1919, under the Revenue Act of 1918, the Commissioner authorized a deduc-

tion for depletion against advance royalty payments. Article 215, Reg. 45. But, instead of recognizing the true function of the statutory allowance for depletion, he deemed it still tied to actual ultimate physical extraction and provided that, in the event the anticipated production failed to materialize within the existing lease, the deductions previously granted would be retroactively disallowed and the income previously received but allocated to capital should be taxed in the aggregate as income for the year the lease terminated. Article 215, Reg. 45 (Preliminary Edition); Article 215(d), Reg. 45 (1920 Edition).

In this we believe he erred. We assume that he thought the termination of a mining lease without extraction, after depletion deducted from income, gave the taxpayer an unwarranted advantage over the Government and that the statute did not cover the case. But he overlooked the fact that the statute fully protected the Government by causing an actual depletion of the taxpayer's basis. If taxpayer recovered a portion of his investment out of advance royalty payments he suffered a corresponding reduction of basis, and no second recovery would be available to him. Thus, even at that early date the statute had a well rounded plan for depletion allowances which fully covered the instant case. There was no need of this regulation.

Too much emphasis was placed on the fact that no ore was mined under the existing lease—too little on the fact that taxpayer's recoverable investment had been reduced. In this light, when the mining lease terminates, the advance royalties received in prior years take on the aspect of the bonus in *Herring vs. Commissioner* (1935), 293 U. S. 322, 79 L. Ed. 389, 55 S. Ct. 179. In that case, a bonus was received on execution of a lease, no production occurred within the taxable year, nor was there any practical assurance in that year of future production. G. C. M. 14448, XIV-1

C. B. 98. Yet, the court held that a part of the bonus constituted return of capital and the deduction therefore must be allowed.

In this light, Mrs. Douglas received a bonus of $107,500.00 in separate annual installments from 1929 to 1936. Of that bonus, $53,299.03 was capital return when received. The termination of the lease in 1937 was not a taxable event —it did not even remove the anticipation of future production. It could not retroactively change the character of proceeds from the property from capital to taxable income.

Herring vs. Commissioner (1935), 293 U. S. 322, 79 L. Ed. 389, 55 S. Ct. 179.

Section 113(b)(1)(B) and Section 114(b)(1).

As a result of the statute, if taxpayers herein should, after termination of the lease, sell their interests, or execute a new lease, their basis upon which to determine gain or loss, or the new depletion rate, is fixed by the Revenue Act at the lower level. And any attempt on the part of the Commissioner to change that basis is in violation of the express terms of Sections 114(b)(1) and 113(b)(1)(B). The Commissioner cannot by regulation change the basis as fixed by the Revenue Act itself.

Since taxpayers' capital to be recovered has been reduced absolutely by the Act, any attempt to tax them on the theory that no depletion has been suffered would be clearly unreasonable and unauthorized by statute. Taxpayers have not "gotten away with something." The Government side of the taxpayer-Government account is compensated for the depletion deductions by the reduction of taxpayers' depletable base.

This solution of the problem leaves the taxpayer and Government in the *status quo* of 1937. Taxpayer's income taxes for prior years remain what they were determined to be. Her

basis remains at the level to which her deductions in prior years had reduced it, and her income tax for the year of termination is computed on her true income and not on her income as inflated by legal fiction. This is the solution which harmonizes with the language, spirit and intent of the Revenue Act. This is the solution which does not violate the established Revenue Act theory of income tax computed on the basis of fixed annual accounting periods. This is the solution which keeps the books closed and looks to the future for adjustment. This is the solution which harmonizes precisely with the second sentence of Section 23(m). It is this solution which avoids the harsh operation of Article 23(m)-10(c). And for these reasons the contrary solution provided by regulation should be held error.

III. The Untaxed Royalties Were Received in Separate Annual Installments in Each of Eight Prior Years; None Was Received in 1937; Even if They Are Income, Treating Them as if All Received in 1937 Is Not in Accord With Fact and Violates Sections 23(m), 41 and 42, Resulting in Hardship and the Practical Denial of the "Reasonable Allowance for Depletion"; Article 23(m)-10(c) Is Therefore Wholly Invalid.

Only the income for the taxable year 1937 was before the Board of Tax Appeals. Internal Revenue Code, Sec. 272(g); *Commissioner vs. Gooch Milling Co.* (U. S.—1943), 88 L. Ed. (Adv. Sheet No. 3) 140, 64 S. Ct. 184.

If we were in receipt of income in years prior to 1937, that factor cannot be taken advantage of to increase our 1937 tax liability. Cf. *Northwestern States Portland Cement Co. vs. Huston, Collector* (C. C. A. 8th—1942), 126 F. (2d) 196.

Thus, if we should be held wrong in our contention that the advance royalties received in years prior to 1937, to the

extent allocated by the Revenue Act to return of capital, were irrevocably and unconditionally applied in reduction of basis, we are not wrong in the fact that the amounts involved were not received in 1937 (R. 37). Even if the Commissioner could raise the basis and retroactively reclassify these untaxed royalties as taxable income he cannot by regulation make them 1937 income.

Separate annual deductions were taken by taxpayers from 1929 to 1936. By reason thereof separate annual portions of royalty received went free of tax because they constituted an apparent return of capital. An aggregate of $53,299.03 in depletion deductions was taken by Bessie P. Douglas over eight taxable years. An aggregate of $53,299.03 royalty *received by her in separate annual amounts over eight taxable years* went free of tax. The Circuit Court held that the $53,299.03 untaxed royalty of eight consecutive years constituted gross income of the ninth year in which *none of it was received*.[21] There can be no clearer case of cumulation of the income of many years.

This Court held in *Burnet vs. Sanford & Brooks Co.* (1931), 282 U. S. 359, 51 S. Ct. 150, 75 L. Ed. 383, that an item of gross income received in a later year could not be drawn back to the year when related deductions were incurred. In effect, this Court held that, where there is no accrual, *the time for inclusion in income is the year in which the item is*

---

[21] R. 79-80.

Also: "The Commissioner's position is not that he [Sneed] got the land back but that the occurrences in 1936 developed a change in status of so much of the money income received in 1926 as then went untaxed because it stood for an anticipated depletion of his oil reserve, and being a return of capital was not income subject to taxation. *Sneed vs. Commissioner* (C. C. A.—5th), 119 F. (2d) 767, 770.

Also: "The Regulation simply provides in effect that when • • • the tax is not paid on a portion of the proceeds • • • then the tax shall later be paid on that portion of the income on which it had not been paid." *Lamont vs. Commissioner* (C. C. A.—8th), 120 F. (2d) 996, 998.

Also: "Finally, the present case is analogous to a number of others, where, with or without a supporting regulation, an adjustment has been made during the taxable year *in which actually no income was received*." *Grace M. Barnett* (1939), 39 B. T. A. 864.

received. And that principle is clearly enunciated in that portion of Section 42 of the Revenue Act of 1936, which provides as follows:

> "The amount of all items of gross income shall be included in the gross income for the taxable year in which received by the taxpayer, * * *."

The cases are legion in which this principle has been applied.[22]

In *Northwestern States Portland Cement Company vs. Huston* (C. C. A. 8th—1942), 126 F. (2d) 196, income received in 1916 and 1917 was held non-taxable in 1932 even though improper deductions were made in 1916 and 1917 in creating a reserve which was credited to surplus in 1932.

In *Hull vs. Commissioner* (C. C. A.—4th), 87 F. (2d) 260, income received in 1925 was held non-taxable in 1926 even though the taxpayer failed to report it in 1925 contending it was not income.

In *Blum vs. Helvering* (U. S. C. A. for D. of C.—1934), 74 F. (2d) 482, income received in 1924 was held taxable in 1924 even though received subject to a contingent liability to pay it out which became fixed and was paid in 1925 resulting in a great loss on the transaction viewed as a whole over the two years. The Court stated (at p. 483):

> "The Supreme Court has held over and over again that a taxpayer may not postpone the payment of the tax then due, in order to ascertain whether the final outcome of the transaction out of which the taxable profit accrued would ultimately result in a gain or a loss. Nothing is now better established than that the assessment of income taxes is on the basis of an annual accounting period, and while, as the Supreme Court has said, conceivably a different system might be devised by which the tax could be assessed wholly or in part on the basis of the finally ascertained result, Congress is not required

[22] For many cases and a general discussion of the time an item becomes income, see *Mertens, Law of Federal Income Taxation*, Vol. 2, Chapter 12. Particularly see Secs. 12.50, 12.14, 12.07, 12.05.

to, and has not adopted such a system. *Burnet vs. Sanford & Brooks Co.*, 282 U. S. 359, 365, 51 S. Ct. 150, 75 L. Ed. 383."

We think the same rule applies here to the Commissioner.

"The concept is fundamental that the law imposes the tax with reference to a fixed period of time. The income tax law is predicated upon annual periods; proving income for a period of years does not prove income for any one year. The annual period is, of course, a matter of necessity if the law is to be administered; it has been called the cornerstone of our tax structure. Naturally it gives rise to efforts of taxpayers to either defer or accelerate items of income or deductions, and the Treasury Department is not entirely free from an inclination to push items around from one year to another when it serves to increase the tax."

Mertens, Law of Federal Income Taxation, Vol. 2, Ch. 12, Sec. 12.06.

Amounts earned in 1918, 1919, 1920 and 1921, required by city ordinance to be held in a revolving fund for future dividends, could not be treated as income for later years but constituted income in separate annual amounts for each of the several years. *Cleveland Ry. Co. vs. Commissioner*, 36 F. (2d) 347.

We are aware of the fact that the cash basis is not immutable. Even the statute recognizes departures therefrom where necessary clearly to reflect income. *Section 42.* But Article 23(m)-10(c) requires a departure from the fundamental rule which causes the clearest possible case of distortion of income. Under it, $53,299.03 is held to be income for one year when, in fact, that amount was received in installments in each of eight separate years, that amount was never received all in one year, and none of it was received in the year for which it is taxed.

This case is the simple story of a taxpayer who took a depletion deduction on her income tax returns each year for

eight years. The law allowed her the deduction and the Commissioner approved it. The law further provided that if she did not take this deduction when she took it she must forego it forever. She could not wait and take it later when ore should actually be mined. By the deduction she saved in eight years $6,923.51.[23] Then, in the ninth year, an event occurred which disclosed for the first time that the reason for permitting the deduction would never materialize under the existing lease. She received notice of cancellation of the lease and no ore had been mined. The Commissioner in the ninth year imposed a tax of $26,550.65 on the untaxed royalties of eight previous years. He computed the tax in the following manner: All of her net income for 1937, exclusive of prior years' depletion, was $53,260.11.[24] To this he added a sum (*i. e.*, untaxed royalty) corresponding to her aggregate depletion deductions for eight consecutive years, $53,299.03 (R. 14). This raised her so-called 1937 net income to $106,559.14 (R. 14), *more than double* her true net income for 1937. The tax on $106,559.14 net income under the 1937 law is $36,499.33 (R. 15). The tax on $53,260.11 is $9,948.68.[25] Thus the tax due to inclusion of prior years' depletion is $26,550.65. This is the price the Commissioner asks of the taxpayer in a single year for her saving of $6,923.51 over the long stretch of eight prior years. The penalty is almost $20,000[26] for having exercised the privilege which Congress, not the Commissioner, granted to her.

The above is a simple but accurate statement of the case. The penalty is the consequence of a regulation promulgated by the Commissioner. The severity of the regulation and

---

[23]$6,923.51 is the difference between her total taxes actually paid from 1929 to 1936 and the total taxes she would have had to pay had she not deducted depletion. See Stipulation of Fact, paragraphs B.9 and B.11 (R. 37 and 38).

[24]This is computed by deducting total past depletion ($53,299.03) from net income computed by the Commissioner ($106,559.14). See Record, p. 14.

[25]This is computed by applying the rates of 1937 to a net income of $53,260.11, which we assert was taxpayer's true net income for that year.

[26]To be precise, the penalty is $19,621.79.

the lack of common sense justification for its oppressive operation lead naturally to questioning its validity. Surely a regulation containing such potentially explosive material must have a sound basis of authority in the statute. And, surely, it must have a common sense reason for existing. The remainder of our brief is devoted to demonstrating that even if, contrary to our contention, an increase in basis is held to be authorized, this regulation is not only unauthorized by statute, but contrary to the statute, and that the common sense result which the regulation was designed to achieve is not in fact achieved in practical operation. Nothing supports our position more eloquently than the harsh and unreasonable result achieved by the regulation in this case.

1. Examination of the facts discloses that:

(a) All of the income[27] sought to be taxed herein was received prior to 1937.

(b) It was received in separate annual periods and is herein attempted to be taxed as though all received in 1937.

(c) The effect of such treatment is to inflict an unjustified penalty on the taxpayer.

We make the simple point that the income which the Commissioner proposes to tax as 1937 income is, in fact, not income at all for 1937. We make the point that the income scooped up by this regulation is part income for 1929, part for 1930, and so on up to 1936. None of it is income for 1937.

It should be borne in mind that all income *actually received in 1937* by Bessie P. Douglas has been reported and

[27]The word "income" is used here and in the remaining portion of this brief on the theory that this Court may hold, against our views, that an increase in basis is within the Commissioner's power. A corollary to the increase in basis is that the prior receipts are to be considered as income instead of capital as originally thought. But the question yet remains "For what years are they income?" We believe the statutory obstacles to cumulating these receipts into one year when none of them were received are insuperable.

taxed and is out of the issues of this case. The issue now under discussion is solely this: Can the Commissioner lawfully add to the income actually received in 1937 the sum of $53,299.03?

What is the income represented by this $53,299.03? And when was it received? The notice of cancellation of lease received in 1937 was not a check for $53,299.03. $53,299.03 is exactly the sum of royalty received which was rendered free from tax by depletion allowed from 1929 to 1936. Thus, it becomes clear that the income represented by the $53,299.03 added to the gross income of 1937 is in reality the untaxed portion of royalties received from 1929 to 1936.[28] Likewise, it becomes clear that the basic issue now under consideration is whether or not the Commissioner can lawfully add to the gross income of 1937 a cumulated total of royalties received and reported in gross income in each of eight years all prior to 1937.

A careful examination of the facts of this case will show clearly the time of receipt of the income which the Commissioner asserts must be taxed as 1937 income. The record of Bessie P. Douglas' royalties and depletion for the eight years appears as follows:[29]

	Royalty Received	Depletion Allowed	Net Taxable Royalty
1929	$ 2,500.00	$ 1,239.51	$ 1,260.49
1930	10,000.00	4,958.05	5,041.95
1931	10,000.00	4,958.05	5,041.95
1932	10,000.00	4,958.05	5,041.95
1933	10,000.00	4,958.05	5,041.95
1934	12,500.00	6,197.56	6,302.44
1935	22,500.00	11,155.61	11,344.39
1936	30,000.00	14,874.15	15,125.85
Total Depletion, 1929-1926		$53,299.03	

[28]This analysis of the facts is the same as that made by the Eighth Circuit in *Lamont vs. Commissioner* (1941), 120 F. (2d) 996, and by the Fifth Circuit in *Sneed vs. Commissioner* (1941), 119 F. (2d) 767, and by the Board in *Grace M. Barnett* (1939), 39 B. T. A. 864.

[29]R. 37, paragraphs B.6 and B.7 of Stipulation of Fact.

If her deduction for depletion be retroactively disallowed, her record would appear as follows:

	Royalty Received	Royalty Previously Taxed	Royalty Previously Untaxed
1929	$ 2,500.00	$ 1,260.49	$ 1,239.51
1930	10,000.00	5,041.95	4,958.05
1931	10,000.00	5,041.95	4,958.05
1932	10,000.00	5,041.95	4,958.05
1933	10,000.00	5,041.95	4,958.05
1934	12,500.00	6,302.44	6,197.56
1935	22,500.00	11,344.39	11,155.61
1936	30,000.00	15,125.85	14,874.15
Cumulated untaxed royalty, 1929-1936			$53,299.03

Three important facts are thrown into relief by the above illustrations: First, they show that the effect of taking the depletion deduction in the first place is simply to render free from tax a portion of the royalty received. This is on the theory that such portion is return of capital, not income. Second, they show that the effect of disallowing the depletion deduction is simply to remove the tax free status of the royalty. This is on the theory that it is all income, no return of capital. Third, and fundamental, neither the allowance nor disallowance can affect the fact that the income in question was not received in 1937. Those royalties were received in *separate annual* installments in each year from 1929 to 1936, inclusive.

The Commissioner's regulation cumulates this untaxed royalty received in annual units and includes in 1937 gross income the aggregate of $53,299.03. All of this amount was never received in one year, and none of it was received in 1937. By fiction the Commissioner has "transferred" the untaxed royalty received in 1929 to 1937. He has done likewise with each of the annual amounts of untaxed royalty for each of the subsequent years to and including 1936.

Let us turn to the words of Article 23(m)-10(c). "The

lessor shall adjust his capital account by restoring thereto the depletion deductions made in prior years on account of royalties on mineral paid for but not removed." We have previously stated the statutory objections to this. But receding from this position for this portion of the argument, we will asume such upward revision of basis proper.[30] Next, "and a corresponding amount must be returned as income." If the Commissioner can raise basis we can no longer object to this. If statutory depletion be held dependent upon actual ultimate extraction under the lease, the untaxed royalty of prior years will be treated as income, not return of capital. Next, "for the year in which such lease expires, terminates or is abandoned." We can and do object to this. None of the untaxed royalty here involved was received in 1937. Some of it was received in 1929, some in 1930, and so on to 1936. This untaxed royalty cannot possibly be income for 1937. The Commissioner cannot by regulation make 1937 income out of 1936 or 1929 income. The facts speak for themselves. And the facts of this case show that the Commissioner by regulation is attempting to cumulate amounts of income allocable to each of a series of eight prior years and to superimpose that accumulation on the taxpayer's real income for 1937.

The unreasonableness of this procedure lies not alone in the fact that these untaxed royalties are classified as income. The unreasonableness lies principally in classifying them as 1937 income. The totally unjustified penalty resulting is the consequence of the utter distortion of the taxpayer's 1937 income. The accumulation of many years' income is suddenly dumped into one year by an artificial device purport-

[30]Only the 1937 income is in issue in this case. If the Commissioner can raise capital account, such revision means that prior royalty receipts were income instead of capital. But the conclusion does not follow that because such revision is made in 1937 that the prior royalty receipts become income for 1937. If the Commissioner can raise capital account the conclusion follows that he should re-assess the tax for each of the prior years and this he could do by appropriate regulation.

edly designed to get back from the taxpayer the benefit derived from use of the deduction. This artificially inflates the taxpayer's gross income for the year from $53,260.11 to $106,559.14. By applying surtax rates applicable in the $50,000 to $100,000 brackets, the regulation recovers for the Government not only the $6,923.51 which the taxpayer saved by deducting a permissible amount, but it strikes her with an additional penalty of nearly $20,000. Why a penalty? By what authority? There is nothing specific in the statute authorizing this. The only alleged justification for Article 23(m)-10(e) which we have seen or heard of is that the taxpayer derived a tax benefit from a depletion deduction and no depletion occurred; therefore he should square up. Assuming the absence of statutory impediment, we could not object to a regulation which in practice squared accounts. But we complain of a regulation which first squares up and then adds a tremendous penalty for which there is neither equitable nor statutory justification.

We have shown how the regulation operates in practical application. We have shown that a costly penalty is imposed. We have claimed that the imposition of this penalty is contrary to statute and thus the regulation is void. We proceed to demonstrate why the regulation is void under the law.

The law of our case is very simple. It rests on the single principle that cumulation of the income of many years is improper. Certainly the taxpayer cannot cumulate his deductions for ten years and deduct the accumulated total in the eleventh year.[31]

There can be no sincere doubt that our income tax law is based fundamentally on the principle of dividing the taxpayer's income into annual periods. Surtax rates are fixed

[31] *Burnet vs. Sanford & Brooks Co.* (1931), 282 U. S. 359, 75 L. Ed. 383, 51 S. Ct. 150. *Burnet vs. Thompson Oil & Gas Co.* (1931), 283 U. S. 301, 306, 75 L. Ed. 1049, 1053, 51 S. Ct. 418.

with the taxpayer's *annual* income in mind. The surtax percentage on $106,559.14 income is obviously intended to hit an annual income of $106,559.14, and obviously not intended to hit a cumulative total of income received in each of many years. Any regulation which destroys the basic concept of a tax based on annual income is necessarily violative of the statute.

Because of this basic concept it becomes important to measure the taxpayer's annual income. The annual income of a cash basis taxpayer is measured by the amount received within the year. *Sections 41 and 42:* When determining the taxability of the receipt of a given $100, it is not enough to answer the question, "Is it income?" Our income tax law is so basically designed to tax income in annual units that it is necessary to answer the further question, "For what year is it income?"

Our case, in this portion of our brief, therefore revolves around the second question only. To-wit, "For what year is the $53,299.03 added to Bessie P. Douglas' gross income taxable?" Even granting that that sum is income, our position is that none of it is 1937 income. The method used by the Commissioner classifies that amount as income for the year 1937. We submit that at this point the Commissioner and his regulation again fall into error. The Commissioner answers the first question by determining that the untaxed royalties were income. If that issue be determined against us, he is yet in error. His error, so far as this portion of the regulation is concerned, consists in determining that those untaxed royalties were income for the year 1937.

We assert that Article 23(m)-10(e) violates specifically the provisions of Section 41, Section 42 and Section 23(m). We shall take these up separately.

2. Article 23(m)-10(c) is in conflict with Sections 41 and 42, Revenue Act of 1936, because (1) it requires income received in one year to be included in the income of a later year in which it was not received, and (2) it cumulates income received in each of a series of years and taxes it as if received in one year.

The material portion of Section 41 is as follows: "The net income shall be computed on the basis of the taxpayer's *annual* accounting period * * *." This is the fundamental concept of our statute. It is a tax on *annual* income. *Burnet vs. Sanford & Brooks Company* (1931), 282 U. S. 359, 75 L. Ed. 383, 51 S. Ct. 150, holds that our income tax is basically founded upon annual determination of income. This being true, it becomes essential to determine the year to which a given item of income belongs.

This is determined by Section 42, the material portion of which provides that "the amount of all items of gross income shall be included in the gross income *for the taxable year in which received by the taxpayer*, * * *."[32] The year for inclusion in gross income is the year of receipt.

From the foregoing, the conclusion is clear that Article 23(m)-10(c) violates the letter and spirit of the statute. The conflict is obvious. The regulation attempts to nullify Section 41 by lumping the income of many years. Section 41 says that such income must not be lumped but must be divided into annual portions. The regulation attempts to nullify Section 42 by putting an item of gross income received in 1929 into the gross income of 1937. And items received in 1930, 1931, 1932, 1933, 1934, 1935 and 1936 into the gross income of 1937. Section 42 says these items must be included in the gross income of the year in which received

[32]Italics ours. The portion of Section 42 omitted from the above quotation permits departure from the strict rule only where departure is necessary clearly to reflect income. See Section 41.

by the taxpayer. Pursuant thereto, they were once so included (R. 37, par. B.6; R. 46). *None* of these items were received in 1937. The regulation is a fictional and artificial device which gathers up the income received in each of a series of years and assigns it to the gross income of a single year. And the cumulation of income thus effected is clearly violative of the fundamental fabric of the law.

Let us follow the effect of cumulation of income a little deeper into the statute. The effect of the violation of Sections 41 and 42 becomes alarming when Section 12 comes into play. Section 12 contains the graduated surtax rates and imposes the tax on "surtax net income." "Surtax net income" is defined as the net income in excess of certain credits. Net income is elsewhere defined as gross income less certain deductions. Accordingly, anything which distorts a taxpayer's gross income will distort his surtax net income. The graduated scale of surtax rates makes obvious the vice of fictionally inflating gross income for any year.

And when the income of many years is ascribed to the gross income of a single year the cumulative penal effect is vastly magnified. Witness the effect of cumulating the untaxed royalties received by Bessie P. Douglas in each of eight separate years and superimposing the aggregate upon her real gross income for the year 1937. The impact of $100,000 surtax rates on a $50,000 taxpayer results in an indefensible penalty. Under the current rates (1942 Act), this would be devastating. Nothing is more clear to us than that Congress had no such eventuality as this in mind in enacting the surtax rates which the Commissioner has applied to the inflated 1937 income of Bessie P. Douglas.

3. Article 23(m)-10(c) is in conflict with Section 23(m), Revenue Act of 1936, because its inherent penal nature in effect denies the statutory "reasonable allowance for depletion."

Let us pass on to an examination of the conflict between Article 23(m)-10(c) and Section 23(m) of the statute. Section 23(m) is the specific section of the statute which Article 23(m)-10(c) is designed to interpret. It provides:

> "* * * a reasonable allowance for depletion * * *, according to the peculiar conditions in each case; such reasonable allowance in all cases to be made under rules and regulations to be prescribed by the Commissioner, * * *."

Yes, the Commissioner is authorized to make regulations governing depletion. But the net effect of his regulations must be to grant a *reasonable* allowance for depletion. A regulation inherently involving an unjustifiable penalty has no place in this framework.

The allowance of depletion against *advance royalties* (*i. e.*, before extraction of ore) is permitted by the statute. In *Herring vs. Commissioner*,[33] the Commissioner attempted to deny the taxpayer's right to deduct depletion against advance royalties (bonus) but this Court held against him.

Now, what happens when a mining lease is terminated and no ore has been extracted? What, if anything, must we do with the taxpayer who has enjoyed the benefits (and suffered the burdens) of a depletion deduction granted to him upon the assumption that he would suffer exhaustion of his mine? Squaring accounts either through reduced depletion in the future, or if that be not the statutory intent, through recomputation of tax for prior years, appears reasonable to us. Squaring accounts is the only theory upon which Ar-

---

[33] *Herring vs. Commissioner of Internal Revenue* (1935), 293 U. S. 322, 79 L. Ed. 389, 55 S. Ct. 179.

ticle 23(m)-10(c) has been supported so far. But the facts of the Bessie P. Douglas case explode any such attempted justification for Article 23(m)-10(c). The total additional tax she would have paid from 1929 to 1936 had she never deducted depletion would have been $6,923.51. The tax due to inserting $53,299.03 in the income of 1937 is $26,550.65. Is this recoupment? Does Article 23(m)-10(c) accomplish its pretended purpose of squaring accounts? By providing the allowance, Congress could not have intended, that when a mining lease terminates, taxpayer should be worse off than if no allowance had been granted.

The imposition of such a penalty is the practical denial of the "reasonable allowance" prescribed by statute. This allowance is not the Commissioner's to give and it is not his to take away. The Commissioner ostensibly obeys the mandate of Congress by allowing depletion against advance royalties. But he renders the allowance unreasonable by packing Article 23(m)-10(c) with such potential dynamite as to render the deduction the source of grave harm to the taxpayer instead of making it the source of benefit to the taxpayer which Congress intended. For this reason we assert that Article 23(m)-10(c) is void because it nullifies the attempt of Congress to provide "a reasonable allowance for depletion" against advance royalties.

We believe we have fully exposed the practical operation of the regulation and the hardships resulting from its inherently unsound principle of cumulation of income. The Board and the Circuit Court recognized the hardship (R. 49, 80). It remains to dispose of the alleged justifications advanced by the Government, the Board, and the Circuit Court of Appeals to support the validity of the regulation and its penal operation.

The Board considered itself reversed by the reference to Article 23(m)-10(c) in the *Murphy Oil Company* case,

though the *Herring* case stated the question was undecided. See *Grace M. Barnett*, 39 B. T. A. 864. At most, the reference in the *Murphy Oil Company* case involved *adjustment of capital account.*[33a] Even assuming it proper to raise the basis, the question of the proper disposition of the corresponding amount of income was not even apparently involved. None of the parties there before the Court was interested in what happens when a mining lease terminates. Almost without discussion of the merits of this case, the Board felt foreclosed by the authority of the *Murphy Oil Company, Sneed, Crabb,* and *Lamont* cases (R. 49).

The Board thereupon introduced the principle of geographic, not intrinsic uniformity, to dispose of our contention that the regulation was unjust and unreasonably harsh (R. 49-50). That principle relates to questions of constitutionality of a law. *Bromley vs. McCaughn*, 280 U. S. 124, 74 L. Ed. 226. We think it has nothing to do with this case. Where an administrative officer is authorized and directed by statute to make such regulations as will provide taxpayers "a reasonable allowance for depletion," we deem it of the very essence of the case and not even open to argument that such regulation must be *reasonable*. We have shown the amount of the penalty imposed on Mrs. Douglas, not for the purpose of showing discrimination against her, nor because the precise dollars-and-cents amount is significant. We have shown that penalty as a perfect illustration of the practical operation of the regulation against taxpayers generally and against her in this case. We consider it a clear exposition of the evils involved in the cumulation of income items received over many years and taxing them on the fictional assumption that they are the income of a single year. In the average case, the penalty will result from the application of *the principle of cumulation of many years' incomes*

[33a] Pp. 304, 306 of 287 U. S.; pp. 323, 324 of 77 L. Ed.

which is inherent in the regulation. It is no answer to this to say that in some other cases and on some other facts no penalty will result. No doubt even under this regulation, some taxpayers, so fortunate as to have a large loss in the year of lease termination, will escape the tax consequences of this descent of non-negotiable "income" upon their heads.[34]

The Circuit Court held erroneous our contention that income of prior years was being used to inflate our income of 1937 (R. 79-80). Its supporting statements are unrealistic. Depletion, says the Court, is "regarded as a reduction, or loss, of capital." The statutory allowance for depletion is a deduction allowed for the purpose of permitting recovery of capital investment out of income from the property. "The status of the depletion deduction then [upon termination of lease], and not until then, changes from capital loss to income both on the books of the lessor-taxpayer and for tax-purposes" (R. 71).[35] Even were we to concede that there exists some process by which the "status" of an item can change from capital to income, such a theoretical meta-

---

[34]Cf. *Langdon-Woven Mines, Inc., vs. Reynolds* (D. C., Minn., 1943), 52 F. Supp. (Adv. Sheet No. 6) 512; 43-2 U. S. T. C., Par. 9534. Here the taxpayer-lessor abandoned the mine when the lease was thrown up and thus avoided tax by offsetting the loss on abandonment against the accumulated "income" prescribed by Article 23(m)-10(c). We regard this case, not as a demonstration of the validity of Article 23(m)-10(c) as suggested by the Board (R. 49-50) and by the Circuit Court (R. 80-81). On the contrary, it is factual demonstration of its capricious results.

Had the lessor retained its mine, and offset the regulation-created income with an outside unrelated loss, the following would have been the peculiar result. No tax would have been due in the year of termination. Tax benefit would have been obtained in previous years from deductions of the apparent return of capital. Yet the regulation would lift the basis to its original level and thus help the taxpayer on its merry way in again deducting the same depletion under some future lease, or in recovering the same capital upon some future sale, or in recovering the same capital out of abandonment in some future year of large income. It is almost unbelievable that the same regulationecould produce such widely varying results in cases of three taxpayers so similarly situated and yet be held reasonable and related to truth instead of the pure fiction which it is.

[35]Cf. "(It) was income when they received it, and is income now." *Lamont vs. Commissioner*, 120 F. (2d) 996.

Also: "Adjustment may have to be made by reporting a balancing item in income for the year in which the change occurs." *Grace M. Barnett* (1939), 39 B. T. A. 864.

morphosis cannot change the fundamental and actual facts as to the time when the item was received. The statute states, and this Court, in *Burnet vs. Sanford & Brooks Co.* (1931), 282 U. S. 359, 75 L. Ed. 383, 51 S. Ct. 150, held, that the *year of receipt* is the controlling factor and not the year in which an alleged change in "status" occurs.

By violating the fundamental rule as to time of receipt, by bunching items received in each of a series of years, the Board and the Circuit Court departed grossly from the principle laid down in the statute and in *Burnet vs. Sanford & Brooks Co., supra*, that income taxes are to be determined on the basis of the taxpayer's *annual* accounting period and on the basis of the net result of all transactions *within the year*. By permitting the cumulation of eight years' receipts the Board and the Circuit Court have sanctioned the imposition of surtax rates, designed only for annual incomes, against an unlawfully distorted net income containing the aggregate of incomes of many years.

Treating these royalty receipts as if they were held in an account or in a fund, in suspension for an indefinite future—a fund which by some process in 1937 changed from capital to income, and from income of prior years to income received in 1937, is fictional. Resort to fiction to sustain the unjust results of this regulation should not stand. In truth these amounts when received by taxpayer were subject only to her unfettered control and available for immediate enjoyment. We do not know where those funds were in 1937. She may have reinvested them in other ventures, she may have given them away, she may have used them for living expenses.

> "Bookkeeping entries do not produce either income or losses for the purposes of taxation. They are intended to record facts, and are evidential, but they do not create or destroy facts."
>
> *Northwestern States Portland Cement Co. vs. Huston*, 126 F. (2d) 196, 199.

Next the Circuit Court states that the deduction was allowed *on the condition* that the corresponding amount (untaxed royalty) be returned as income for the year of termination (R. 80). This begs the whole question in the case. It is of the very essence of this case to determine whether the Commissioner had authority to impose this condition and yet stay within the express mandate of the statute to give a "reasonable allowance for depletion," and the implied mandate not to violate other parts of the Revenue Act. The Circuit Court states at one point "The taxpayer is given an option to take or not to take a deduction for depletion" (R. 81). At another point, "This is the condition upon which the deduction is allowed" (R. 80).[36]

Let us have a look at that option and that condition. The deduction for depletion was proper when taken. *Murphy Oil Co. vs. Burnet*, 287 U. S. 299, 77 L. Ed. 318, 53 S. Ct. 161; *Herring vs. Commissioner*, 293 U. S. 322, 79 L. Ed. 389, 55 S. Ct. 179; Section 23(m), Revenue Act of 1936, and corresponding sections of prior Revenue Acts; Article 23(m)-10(b), Regulation 94, and corresponding provisions of prior regulations. Not only was it proper when taken, taxpayer had to take it when it was taken or forego it forever. She could not wait until actual mining began and take it contemporaneously and co-extensively with extraction of ore. That is what the *Murphy Oil Co.* attempted to do. But this Court sustained the Commissioner's contention that depletion must be taken, if at all, in the year when advance royalties are received. See also, *Herring vs. Commissioner, supra.* Even if she had decided to forego depletion rather than incur the grave risks of Article 23(m)-10(c), the statute itself would reduce her basis for depletion to the same extent as if she had taken it. *Section 113(b)(1)(B).*

---

[36] "The deduction allowed for 1934 was proper but was granted conditionally. The petitioner by accepting the deduction also accepted the condition provided in the regulations." *Grace M. Barnett* (1939), 39 B. T. A. 864.

Thus, what is termed an "option" turns out to be no option at all.[37] Taxpayer could not choose to postpone the deduction to the time when actual extraction occurs. She could not even choose to forego the deduction completely without suffering the statutory depletion of her basis. Even if she refused forever the recovery of investment proffered by Section 23(m), she would be treated by Section 113(b)(1)(B) as having recovered her investment to the extent of the depletion "allowable." Thus, she is compelled to take her deduction in the year of advance payment.

To hold that, under the same statute giving the administrative officer a mandate to provide by regulation a "reasonable allowance for depletion," the Commissioner can make one regulation *requiring*[38] the taxpayer to deduct his depletion when advance payments are made and another subjecting him, if he does so, to this yearly accretion to a swelling reservoir of potential future tax liability, is to defeat the statute.

To hold that a statute which, in one part, confers a beneficial deduction on the taxpayer, and, in another part, reduces his recoverable investment to the extent that deduction is allowable whether taken or not, also intends to impose these disastrous future tax consequences upon him simply because he takes it and subsequent events show both him and the Commissioner to have been wrong, is equally to defeat the statute.

To force the taxpayer by regulation to gamble on the future, and by statute to reduce his basis if he chooses not to gamble, where, the obvious intent of Congress was that he should take a deduction, is to our minds most unreasonable. We are confident that Congress intended no such squeeze

---

[37] "It may be described as the injustice of illusory opportunity." *Maguire & Zimet, Hobson's Choice in Federal Taxation*, 48 Harvard Law Review 1281.

[38] *Herring vs. Commissioner*, 293 U. S. 322, 79 L. Ed. 389, 55 S. Ct. 179. *Murphy Oil Co. vs. Burnet*, 287 U. S. 299, 77 L. Ed. 318, 53 S. Ct. 161. Art. 23(m)-10(b), Reg. 94.

to be applied to the taxpayer. Thus, we say that the taxpayer had no real option and that the Commissioner clearly exceeded his statutory authority in imposing this condition upon the exercise of the statute-granted right of deducting depletion. Even if there were no other violations of statute involved, this condition was an unreasonable one and consequently not authorized by Section 23(m). In addition, this condition involved the violations of other statutory provisions previously discussed.

This rule that the deduction must be taken, if at all, in the year in which the advance royalty is received, combined with the annual statutory reduction of basis, effectively blocks all justification for Article 23(m)-10(c) based upon the grounds of estoppel or implied consent of the taxpayer derived from the taking of the deduction. If there be any estoppel, it is against the Commissioner who *required* the deduction to be taken in advance of extraction.

Suppose Mrs. Douglas had not taken any depletion from 1929 to 1936. Her basis would nevertheless have been reduced by the annual operation of Section 113(b)(1)(B) to the extent of $53,299.03. Nor would there be anything in Article 23(m)-10(c) authorizing an upward adjustment of basis when the lease terminated because there would have been no "depletion deductions made in prior years." To say, as the Circuit Court said, that she had an "option to take or not to take" the deduction is surely stretching the meaning of the word option.

We believe we are right if we insist that the authority delegated to the Commissioner under Section 23(m) is not without limitation, and that at least his regulations must provide "a reasonable allowance for depletion," and must not conflict with other parts of the statute. To condition an allowance which had to be taken, if at all, when taken, which causes a reduction of basis whether taken or not, upon

the restoration of a corresponding amount in conjunction with other corresponding amounts to the income of some unknowable future year, is to make the original allowance unreasonable. To condition by regulation the statutory allowance for recovery of investment in such a way as to make it more desirable to forego such recovery is, in effect, to deny the reasonable allowance intended by Congress, to tax the recovery of capital, and thus defeat the statutory aim.

Next, the Circuit Court held depletion analogous to a liability reserve, citing *Maryland Casualty Company vs. United States*, 251 U. S. 342. The analogy is not good. To begin with, the insurance company was on an accrual basis. Part of the gross premiums received by it was required by law to be set aside into a specific fund to be held by it for the reason that liabilities for unearned premiums had accrued. Special statutory provision was required to make this deductible because in the absence of statute a liability indeterminate in amount is not "accrued." Thus, for purposes of the Revenue Act this liability had accrued. Then in a year when the liability ceases, income is held to have been received. But *the income* which is taxed is not the money received in the prior year. *Cessation of liability* in the subsequent year causes a gain in assets available for dividends which is *the income* which is taxed and it is taxed in the year in which received. *U. S. vs. Kirby Lumber Co.* (1931), 284 U. S. 1, 76 L. Ed. 131, 52 S. Ct. 4; *Helvering vs. American Chicle Company* (1933), 291 U. S. 426, 78 L. Ed. 891, 54 S. Ct. 460; Article 22(a)-14, Regulations 94. Cf. *Helvering vs. American Dental Co.* (1943), ... U. S. ..., 87 L. Ed. (Adv. Sheet No. 10) 574, ... S. Ct. ....

In accounting principles and practice there is a clear distinction between a depletion or depreciation "reserve" and a liability "reserve." This is not just a technical distinction but a very real one and based upon a material distinction

in the facts. The depletion reserve is technically known as a "Valuation Reserve" and is merely a device to show the reduction in capital investment. On any modern corporate balance sheet it will show as a deduction from the investment account to show at a glance the original cost (basis) of the asset, the deduction for depletion (depletion reserve), and the net remaining investment (adjusted basis). In no way does it represent assets held in a fund subject to any liability. There is no liability. On the other hand, liability "reserves" are nothing more or less than accrued liabilities.[39] To call "depletion reserve" an asset which becomes "released for general use," when in fact it is a measure of the reduction of original cost, is based upon a misconception of the facts. It is neither good law nor good accounting. The Treasury Regulations recognize the nature of "depletion reserves" in providing that taxpayer may deduct depletion directly from the investment account thus showing only the net cost (adjusted basis) or he may keep his original capital account (basis) intact and credit depletion to a "Depletion Reserve" which if deducted at any time from original cost (basis) will reflect at any time the remaining recoverable investment (adjusted basis). Article 23(m)-11, Regulations 94. The two are the same.

In our case, upon receipt of advance royalties no liability existed. Taxpayers were free to dispose of them as they then pleased and as such they constituted income, if at all, only in those years. Determination, in 1937, that those royalties were not in fact capital when received may retroactively

---

[39]For discussions of this distinction between valuation reserves and liability reserves see:

(a) R. H. Montgomery, *Auditing Theory and Practice*, Sixth Edition, Ronald Press, 1940, p. 242.

(b) Kester, *Advanced Accounting*, Third Revised Edition, Ronald Press, 1933, p. 571.

(c) Gilman, *Analyzing Financial Statements*, Revised Edition, Ronald Press, 1934, pp. 234-237.

(d) Finney, *Principles of Accounting*, Prentice Hall, Inc., 1937, Vol. 1, Intermediate, p. 379.

change their character into income but it cannot change or destroy the facts that, if income, it was received all in years prior to 1937 (R. 37) and must be taxed, if at all, for the years in which received. Extinguishment in 1937 of "Reserve for Depletion" extinguishes only the "offset" against the invested capital account. It does not "release" any assets for general use. Superficial analogies cannot save the regulation from the charges that it is (1) unreasonable thus violating Section 23(m) and (2) repugnant to other provisions of statute.

The Circuit Court then stated, "The same rule applies to deductions for depreciation" (R. 80). This simply is not true. Even excessive and improper deductions for depreciation are deducted from taxpayer's basis. And, upon discovery, in some subsequent year, of the fact they were excessive, the basis remains reduced and the depleted basis is spread over the future life of the property. See the example in Treasury Regulations 94, Article 23(l)-5. Cf. *Virginian Hotel Corporation vs. Commissioner* (1943), 319 U. S. 523, 87 L. Ed. 1149, 63 S. Ct. 1260. This is precisely the treatment we are contending for in the preceding part of this brief. This is the treatment we believe is provided for by the statutory provisions relating to depletion. The estoppel applied against taxpayers who take excessive depreciation deductions is an estoppel preventing an increase in basis for subsequent taxable years. There is no statutory authority for reversing this procedure with respect to depletion.

The bad debt recovery cases have been advanced as authorities against our contention that income must be taxed to a cash basis taxpayer for the year in which received. Where a deduction for bad debts is made from gross income and results in a reduction of tax, all are now agreed that if payment of the debt is received in a subsequent year it is taxable in the year in which received. The statement of the case

carries the obvious distinction. The money taxed as income is received in the year for which it is taxed. The issue in such case is whether or not the events of prior years justify treating the cash recovery as income rather than capital in the year in which received. The Commissioner's contention in our case is not that we received cash or cash equivalent in 1937, but that the events of 1937 developed a change in the status of cash received in prior years, and that change of status not only justifies treating the prior receipts as income but justifies "transferring" them to 1937 and treating them as if received in 1937 while admitting they were not (R. 79-80).

Lamont vs. Commissioner (C. C. A.—8th), 120 F. (2d) 996, 998.

Sneed vs. Commissioner (C. C. A.—5th), 119 F. (2d) 767.

To treat payment of a previously deducted bad debt as capital would permit a double escape from tax with respect to the same item.

Cf. *Charles Ilfeld Co. vs. Hernandez* (1934), 292 U. S. 62, 68, 78 L. Ed. 1127, 1131, 54 S. Ct. 596.

Griffiths vs. Helvering (1939), 308 U. S. 355, 84 L. Ed. 319, 60 S. Ct. 277.

In our case, no double deduction can occur. *Section 113(b)(1)(B). Article 23(m)-11, Regulations 94.* In fact, by requiring the inclusion of these untaxed royalties in 1937 gross income, the Commissioner compels a double inclusion in gross income—a case unique in our experience of income tax law and one which must require the clearest sort of statutory authority to sustain it. The estoppel, if any, works against the Commissioner who required the deduction to be taken against advance payments.

"If there was any misleading, it was done by the Commis-

sioner * * *." *U. S. vs. Scott & Sons, Inc.* (C. C. A. 1st—1934), 69 F. (2d) 728, 732. "There would be just as much ground for the taxpayer to claim that the Government is estopped to change its position." *Sugar Creek Coal & Mining Co.* (1934), 31 B. T. A. 344.

The bad debt recovery cases, in turn, bring up the entire issue of the so-called "tax-benefit theory" as applied to this case. In addition to recoveries of bad debts, there are cases of recoveries of taxes previously paid, recoveries of insurance for previously deducted losses, recoveries of purchase price on rescission of stock sales, and other similar recoveries. These recoveries are in the nature of replacement of capital or reimbursement of expenses. In the absence of tax benefit or offset of gross income in prior years, even though ineffective deductions were claimed, such recoveries are treated as what they in fact are, and not as taxable income. *Dobson vs. Commissioner* (Dec. 20, 1943), ... U. S. ..., 88 L. Ed. (Adv. Sheet No. 4) 179, 64 S. Ct. 239. Cf. Section 116, Revenue Act of 1942, 56 Stat. 798, 812, C. 619, 26 U. S. C. A., 1942 Supp., Sec. 22 (now, Sec. 22(b)(12), I. R. C., relating to bad debt recoveries, tax refunds, and "delinquency amounts.") If, however, by the deduction in the previous years, the taxpayer has offset gross income he has recouped, out of income and without tax, sums sufficient to replace such capital or expense items. *Dobson vs. Commissioner* (relating to taxpayer Harwick, No. 47), *supra*, at page 189 of 88 L. Ed. If in the later year the taxpayer recovers the payment of a debt, or insurance for a loss, or a refund of taxes paid, or a return of purchase price of stock previously charged off against taxable income as a capital loss, it would not be right to permit him to consider such cash recovery as return of capital or as reimbursement of former expense because he has previously recouped a similar sum out of income by his prior deduction. Hence, a kind of

estoppel is applied against him, preventing him from claiming or treating such cash recoveries as return of capital or reimbursement of expense, which in reality they are, and requiring him to treat such cash recovery as taxable income, instead, in the year in which recovered. This is a rule which has been developed by the Courts in the absence of any specific statute governing the case. Tax benefit or offset of gross income in prior years estops him from treating as recovery of capital sums received in the later year, which amounts are treated in the later year as replacements of the income of the prior year which escaped tax by allocation to capital.[40]

The only point of similarity between our case and those cases is that we obtained tax benefit and offset of gross income by deducting depletion in prior years. But, we did not receive $53,299.03 in the taxable year 1937. The tax benefit theory is now urged against us to create an estoppel preventing us from claiming that sums received in annual installments from 1929 to 1936, allocated to capital in those years, do not assume the "status" of income for 1937. The fundamental distinction between our case and the tax benefit cases is that we did not receive the sum which is taxed as income in the year for which the tax is asserted. Our case is directly covered by statute, which was not true in those cases. The estoppel, provided by statute as we contend, or even independently of statute, derived from our tax benefit of earlier years is an estoppel preventing us from increasing our basis by the amount of the sums recovered in prior years, which we then thought were capital. It is an estoppel pre-

[40]This distinction between deductions which effect a recoupment out of income even though no tax saving results therefrom, and deductions which neither offset gross income nor produce tax saving, is set forth by the Board in our case at R. 52. Congress and the Treasury, however, dropped the distinction between "tax benefit" and "offset of gross income" as developed by the Board of Tax Appeals, when it enacted Section 22 (b) (12), I. R. C., relating to bad debt recoveries, tax refunds, and "delinquency amounts." Sec. 29.22(b)(12)-1 (b) (2), Regulations 111.

venting us in 1937 from using our undepleted basis for future like recoveries. Cf. *Virginian Hotel Corporation vs. Commissioner* (1943), 319 U. S. 523, 87 L. Ed. 1149, 63 S. Ct. 1260, where, had the excessive depreciation of prior years resulted in tax benefit, this Court, taxpayer, and Commissioner would have been in accord. Cf. also, *Murphy Oil Co. vs. Burnet* (1932), 287 U. S. 299, 77 L. Ed. 318, 53 S. Ct. 161.

Thus, we believe that the tax benefit theory has no proper application to our case because the statute, in Sections 114(b)(1) and 113(b)(1)(B), provides what is to happen to us because of the benefits derived from our deductions. And even if the statute did not so provide, the tax benefit theory should only result in keeping our basis reduced and not in cumulating amounts received in prior years and imposing the tax thereon as if such amounts were all income for some one later year. Further, even if basis can be raised and even if the prior receipts take off their capital "disguise," the tax benefit theory applied consistently with the other tax benefit cases should result only in taxing them in the respective years in which received.

It is only where the tax benefit theory is carried to the extreme result claimed by the Commissioner in this case, that is, it is only when Article 23(m)-10(c) is held valid, that we are forced to turn around and accept the Commissioner's claim at its face value and assert that Article 23(m)-10(c) is therefore invalid as applied to deductions which produced no tax benefit in prior years.

We have been met by the argument that deductions are matters of grace and therefore we cannot complain of the injustice attached to this deduction. This ignores the fact that deductions are matters of *legislative* grace and not blessings bestowed upon taxpayers by the Commissioner. Congress did not attach an unreasonable condition to the "reasonable allowance for depletion." This likewise ignores the

fact that this case directly involves only an item of alleged gross income. Retroactive disallowance of the deduction, if the statute be construed to permit it, can do nothing more than increase the taxable net income for each prior year. It cannot increase gross income for any year.

In summation, it is our position that even assuming statutory authority to wipe out past depletion deductions, it is repugnant to statute for the Commissioner to treat the cumulated income of prior years as if all received in one year. Such treatment destroys the annuality of the concepts of gross and net income thus creating a gross distortion of income and thus violating Sections 41 and 42, Revenue Act of 1936. It results in the indefensible application under Section 12(a) of surtax rates in the high brackets never intended to be applied to such "income." It imposes a penalty on taxpayer leaving her in a worse position than if she had never heard of the deduction for depletion, which cannot be what Congress intended by a "reasonable allowance." A regulation more radically repugnant to statute or more unreasonable in result could hardly be devised.[41] The Circuit Court erred as a matter of law in sustaining it.

IV. Assuming This Court Should Hold the Regulation Valid, It Should Not Be Applied to Deductions Taken When the Regulation Was Not in Effect.

When petitioners took their deductions in 1929, the regulation had been revoked by the Commissioner's published acquiescence in the Board decisions of *Knapp* (1927), 7 B. T. A. 790, and *Cooper* (1927), 7 B. T. A. 798. See acquiescenses at VII-1 C. B. 17, and VII-1 C. B. 1, respectively.[42]

---

[41]Cf. "There could be a no more necessary or a more reasonable regulation prescribed. * * *" *Lamont vs. Commissioner*, 120 F. (2d) 996, 998. Two more reasonable regulations have been hereinbefore suggested; we believe the statute provides the most reasonable solution of all.

[42]For effect of acquiescence, see for example, XIII-2 C.B., p. iv.

Stronger or plainer language could not be chosen than—

> "How excessive deductions allowed in prior years can, upon the happening of a specified event in a subsequent year become income, is beyond our comprehension."
> *Knapp*, 7 B. T. A. 790, 792.

When the instant taxpayers took their deductions in 1929, 1930 and 1931 they were assured by the Board and by the highest authority in the Bureau of Internal Revenue that they would not be subjected to future liability therefor. The regulation was reprinted as Article 236 of Regulations 74 (1928 Act) which remained in effect until after the Commissioner withdrew acquiescence in 1932, but was disregarded in official Treasury practice.

When, in 1932, the Commissioner withdrew acquiescence in the *Knapp* and *Cooper* cases,[43] thus announcing that the regulation was again in effect, he could not lawfully give retroactive effect to it. To do so under a statute commanding a "reasonable allowance for depletion" would be the clearest inequity and the clearest volation of that statute.

> Compare, "We are asked to make a retroactive holding that for some seven years past a multitude of transactions have been taxable although there was no source of law from which the most cautious taxpayer could have learned of the liability. If he consulted the decisions of this Court, he learned that no such tax could be imposed; if he read the Delphic language of the Act in connection with existing decisions, it, too, assured him there was no intent to tax; if he followed the congressional proceedings and debates, his understanding of nontaxability would be confirmed; if he asked the tax collector himself, he was bound by the Regulations of the Treasury to advise that no such liability existed. It would be a pity if taxpayers could not rely on this concurrent assurance from all three branches of the

[43] Even after the withdrawal of acquiescence in 1932, these taxpayers had the assurance of the Board of Tax Appeals that their deductions would be held final. The Board did not reverse itself until 1939. *Grace M. Barnett*, 39 B. T. A. 864.

Government. But we are asked to brush all this aside and simply to decree that these transactions are taxable anyway."

Helvering vs. Griffiths (1943), ... U. S. ...., 87 L. Ed. (Adv. Sheet No. 10) 597, 615, ... S. Ct. ....

We are of the opinion that this regulation can not lawfully be applied to any deduction for depletion here involved taken prior to the date of withdrawal of acquiescence in the *Knapp* and *Cooper* decisions. (July-December, 1932, XI-2 C. B. 14 and 12.)

V. Depletion Deductions Resulting in No Tax Reduction When Taken Should Not Be Included in Gross Income in the Year of Termination of Lease.

In 1933 Bessie P. Douglas had a net loss of $8,989.46 without benefit of the deduction for depletion ($4,958.05) which she wrote on her return (R. 41-42). The Commissioner, while justifying Article 23(m)-10(c) on the theory that tax saving in prior years necessitated *recoupment*,[44] nevertheless, insisted upon the addition of that amount to 1937 income. The Board held the regulation invalid as applied to such a deduction (R. 56-57). The Circuit Court reversed the Board on the authority of its own recent decision in *Dobson vs. Commissioner* (Sub. nom. *Harwick vs. Commissioner*), 133 F. (2d) 732 (R. 87, 93), on the ground that the Board's decision was not in accordance with law. The Circuit Court held that it injected "into the law of deductions an equitable consideration contrary to the strict construction required to be placed upon statutes allowing deductions" (R. 93). We think Congress injected this principle of equity and fairness when it used the word "reasonable"

[44] "Ordinarily, the government may recoup only by restoring the deduction to income and asserting the tax against the taxpayer in the year of termination of the lease." G. C. M. 14448, XIV-1 C.B. 98.

in Section 23(m). The Board to that extent was clearly right. The Circuit Court's decision, upon which it relied to reverse the Board in our case, was reversed by this Court in *Dobson vs. Commissioner* (Dec. 20, 1943), ... U. S. ..., 88 L. Ed. (Adv. Sheet No. 4) 179, 64 S. Ct. 239.

If the meaningless writing on a prior income tax return did not estop the taxpayer, Dobson, from sustaining the claim that a large sum of cash actually received within the taxable year was not taxable income, it cannot estop the taxpayer, Douglas, from asserting that capital recovered in a previous year did not turn to taxable income in the taxable year when nothing was received. *Dobson vs. Commissioner* (Dec. 20, 1943), ... U. S. ..., 88 L. Ed. (Adv. Sheet No. 4) 179, 64 S. Ct. 239.

A similar situation exists with respect to a similar deduction taken by Bessie P. Douglas in 1934. In that year, after deducting depletion she had a net income of $3,160.10. She could, under the 1934 Revenue Act, have had $4,000 net income without either normal or surtax.[45] Thus to the extent of $839.90 her depletion deduction produced no tax benefit. There being no tax saving resulting from that $839.90, this amount should be treated identically with the 1933 deduction.[46] The Board, however, drew a somewhat tenuous distinction between the case where other deductions offset gross income and this case where it takes other deductions to partially offset gross income plus "credits" to offset the net income. This distinction was based upon the concept that replacement of *capital* out of "taxable income" in prior years,

---

[45]Surtax commenced only after net income reached $4,000. Sec. 12(b), Revenue Act of 1934. Dividends received credit plus earned income credit ($5,894.05 plus $300 (R 41-42)) would have permitted net income to increase up to $6,194.05 without normal tax.

[46]Had the attention of Congress been drawn to deductions for depletion, when it enacted Section 22 (b) (12), I. R. C., this item of $839.90 would have constituted a "recovery exclusion" according to Reg. 111, Section 29.22(b)(12)-1(b)(2), being that portion of the deduction which could be disallowed without causing an increase in tax for 1934.

even though no tax reduction resulted, prevented a second recovery of capital without tax in the subsequent year (R. 52). This reasoning is not applicable in our case where there is only the recovery of the prior year—no funds, capital or income, were recovered in 1937. The closing remarks of this Court in the *Dobson* case (relating to taxpayer Harwick, No. 47) likewise apply to cases involving a second recovery in the subsequent taxable year. In our case there is no second recovery. In our case the statute gives more than an "inkling" of what should be done.[47] *Section 23(m).*

The 1932 deduction of Estate of Charles H. Robinson, No. 132, involves facts like the 1934 deduction of Mrs. Douglas. The estate was entitled to a personal exemption of $1,000 against a net income of $620.87 after deducting depletion (R. 39). Thus, to the extent of $379.13, the depletion deduction effected no reduction in tax. It should be treated identically with the 1933 and 1934 deductions of Bessie P. Douglas.

Where the only alleged justification for the validity of a regulation is the recoupment of tax benefits of prior years, to hold it applicable to the 1933 deduction of Bessie P. Douglas, as the Circuit Court did, is inconceivable. To distinguish between the 1933 deduction on the one hand and the 1934 and 1932 deductions on the other, as the Board did, is to deal in refinements beyond the point of reason.

---

[47] "The statute gives no inkling of the correctness or incorrectness of the Tax Court's view, and we can find no compelling reason to substitute our judgment." *Dobson vs. Commissioner* (Dec. 20, 1943), ... U. S. ..., 88 L. Ed. (Adv. Sheet No. 4) 179, 64 S. Ct. 239.

VI. The Regulation Was Not Validated by Enactment of the Revenue Acts.

As previously pointed out Article 23(m)-10(c), Regulations 94, or its counterpart has been in all regulations issued since Regulations 45 promulgated in April, 1919, under the 1918 Revenue Act and continues currently as Section 29.23(m)-10(c) of Regulations 111 issued under the Internal Revenue Code as amended. For some unexplained reason it was reprinted as Article 236 of Regulations 74 (1928 Act) although disregarded in official Treasury practice by reason of the Commissioner's acquiescence in the *Knapp* and *Cooper* cases.

At no time prior to 1939 was there a decision of any judicial body sustaining validity of Article 23(m)-10(c). From 1927 to 1939, the Board of Tax Appeals' position was that it was invalid. From 1927 to 1932, the official Treasury position was that it was invalid. We are at a loss to understand how reenactment of the Revenue Act served as Congressional approval of this relatively obscure provision of the regulations. The enactment of the Revenue Act of 1928, just as much and even more logically, gave Congressional approval of the Board's decisions of 1927 and the Commissioner's acquiescence therein.

An invalid regulation is a mere nullity. If the regulation is unreasonable or lacks statutory authorization, the subsequent reenactment of the statute does not make law out of the regulation. The regulation is of no force or effect.

> "'The power of an administrative officer or board to administer a federal statute and to prescribe rules and regulations to that end is not the power to make law—for no such power can be delegated by Congress—but the power to adopt regulations to carry into effect the will of Congress as expressed by the statute. A regulation which does not do this, but operates to create a rule

out of harmony with the statute, is a mere nullity. *Lynch vs. Tilden Produce Co.*, 265 U. S. 315, 320-322, 68 L. Ed. 1034-1036, 44 S. Ct. 488; *Miller vs. United States*, 294 U. S. 435, 439, 440, 79 L. Ed. 977, 980, 981, 55 S. Ct. 440, and cases cited. And not only must a regulation, in order to be valid, be consistent with the statute, but must be reasonable. *International R. Co. vs. Davidson*, 257 U. S. 506, 514, 66 L. Ed. 341, 346, 42 L. Ed. 179. The original regulation as applied to a situation like that under review is both inconsistent with the statute and unreasonable."

Manhattan General Equipment Co. vs. Commissioner (1936), 297 U. S. 129, 134, 80 L. Ed. 538, 56 S. Ct. 397.

In the case of *F. W. Woolworth Co. vs. United States* (C. C. A. 2nd—1937), 91 F. (2d) 973, the Court stated:

"The reasoning by which such rulings are deemed to be incorporated into the law upon its reenactment are familiar, and we should have no right to disregard it, whether or not in a given instance it represents a real assent by Congress. But not every ruling is incorporated in the text because it is not repudiated; no one has ever suggested anything of the sort. At most, administrative practice is a weight in the scale, to be considered, but not to be inevitably followed. Here the inference is a good deal weaker than usual because it rests upon an interpretation applicable to the British act which is but a part of all the section covers. To suppose that Congress must particularly correct each mistaken construction under penalty of incorporating it into the fabric of the statute appears to us unwarranted; our fiscal legislation is detailed and specific enough already. While we are of course bound to weigh seriously such rulings, they are never conclusive; here, it seems to us that they are not enough to turn the scale."

Numerous other decisions have announced the rule and its limitations but no opinion has more forcefully exposed the faulty reasoning behind it than that in the case of *Helver-*

ing vs. Hallock (1940), ... U. S. ..., 84 L. Ed. 383.[48] The *Hallock* case overruled the eight-year-old *St. Louis Trust Co.* case. Between these two cases the Revenue Act was reenacted and amended a number of times. The argument was advanced that, in view of the reenactment of the law, Congress had approved the construction placed upon the statute by the *St. Louis Trust Co.* case and that construction must now be considered as the true meaning of the statute. In refutation of this argument this Court said:

> "Nor does want of specific Congressional repudiations of the *St. Louis Trust* case serve as an implied instruction by Congress to us not to reconsider, in the light of new experience, whether those decisions, in conjunction with the *Klein* case, make for dissonance of doctrine. It would require very persuasive circumstances enveloping Congressional silence to debar this Court from reexamining its own doctrines. To explain the cause of non-action by Congress when Congress itself sheds no light is to venture into speculative unrealities. Congress may not have had its attention directed to an undesirable decision; and there is no indication that as to the *St. Louis Trust* cases it had, even by any bill that found its way into a committee pigeon-hole. Congress may not have had its attention so directed for any number of reasons that may have moved the Treasury to stay its hand. But certainly such inaction by the Treasury can hardly operate as a controlling administrative practice, through acquiescence, tantamount to an estoppel barring reexamination by this court of distinctions which it had drawn. Various considerations of parliamentary tactics and strategy might be suggested as reasons for the inaction of the Treasury and of Congress, but they would only be sufficient to indicate that we walk on quicksand when we try to find in the absence of corrective legislation a controlling legal principle."

---

[48]See also: Erwin N. Griswold, *A Summary of the Regulations Problem*, 54 Harvard Law Review 398. Robert C. Brown, *Regulations, Reenactment, and the Revenue Act*, 54 Harvard Law Review 377. A. H. Feller, *Addendum to the Regulations Problem*, 54 Harvard Law Review 1311. Erwin N. Griswold, *Postscriptum*, 54 Harvard Law Review 1323.

If the reenactment of the Revenue Act without change does not incorporate into the statute the construction placed upon it by decision of the highest judicial authority of the land, after that construction has been subjected to the searchlight of litigation, it is hard to conceive of any reason why the interpretation of the Commissioner of Internal Revenue should by the same process be placed beyond the realm of judicial scrutiny. If the Supreme Court is not barred by intervening reenactment from examining its own decisions on construction, how can it be barred from examining the decisions of the Commissioner? All of the arguments in the *Hallock* case apply with redoubled force where a mere regulation is involved.

Nor does the age of this regulation entitle it to greater dignity or respect. Taxpayers generally have not worsened their positions by reliance upon its validity as, for example, they had in the non-taxable stock dividend cases. *Helvering vs. Griffiths* (1943), ... U. S. ..., 87 L. Ed. (Adv. Sheet No. 10) 597, 615, ... S. Ct. .... If the regulation be held valid many will worsen their positions by declining the "benefits" of the "reasonable" allowance for depletion against advance payments. A decision declaring the regulation invalid will lift an oppressive burden from taxpayers who, for many years past, have been recipients of bonuses or advance royalties and who are faced with this explosive and unpredictable liability should the contingency some future day occur. Yet, such a decision will leave them to bear the burden in an orderly fashion in years subsequent to lease termination. Such a decision will relieve the already dominant mining company lessees of their most effective weapon for beating down a fair royalty rate by threat of cancellation when a sufficient back log of "chameleonic capital" has been built up over the lessor-taxpayer's head.

VII. The Circuit Court Had Full Jurisdiction to Reverse the Board and Should Have Done so on the Ground That the Board's Decision Was Contrary to Law.

We have left the question of jurisdiction to the last because we feel that a full exposition of the case shows that the decision of the Board was based upon, not one, but several clear errors of law.

At no time have the facts been in dispute. The facts were either alleged and admitted in the pleadings or resolved by stipulations of fact (R. 36-43). The Board of Tax Appeals specifically adopted the stipulations as its findings of fact (R. 45). It found the facts as we view them and as we have stated them herein.

Our contention in the Board, as in the Circuit Court and here, was and is that there is no authority in the Revenue Act for promulgation of this regulation and that the regulation as promulgated is in conflict with the statute. On petitions for review to the Circuit Court we assigned certain conclusions of law drawn by the Board from the agreed facts as errors of law (Petition for Review, pars. III and IV, R. 57). We think the case involves pure questions of law and in consequence thereof the Circuit Court had full jurisdiction to reverse the decision of the Board of Tax Appeals: *Dobson vs. Commissioner* (Dec. 20, 1943), ... U. S. ..., 88 L. Ed. (Adv. Sheet No. 4) 179, 64 S. Ct. 239.

It is our contention that the applicable statutes forbid the method of calculation of the deficiencies determined by the Board of Tax Appeals. As such, the Board's conclusions of law drawn from the agreed facts and the decision entered pursuant thereto was not "in accordance with law" and the Circuit Court was empowered to reverse it. Revenue Act 1926, Sec. 1003(b), 44 Stat. 9, 110, C. 27, now I. R. C., Sec. 1141(c)(1), 26 U. S. C. A., 1940 Ed., Sec. 1141(c)(1).

We further believe that we have demonstrated that Article 23(m)-10(c) of Regulations 94, was wholly unauthorized by the Revenue Act, in conflict therewith, and wholly unreasonable in practical operation and result. Both the Board of Tax Appeals and the Circuit Court of Appeals clearly erred as a matter of law in sustaining it.[49]

Respectfully submitted,

JAMES E. O'BRIEN AND
KIMBALL B. DEVOY,
Attorneys for Petitioners,
808 First National-Soo Line Building,
Minneapolis, Minnesota.

Of Counsel:
THOMAS P. HELMEY,
1100 First National-Soo Line Building,
Minneapolis, Minnesota.

[49]We are aware of the fact that usually a decision of the Board is entitled to weight but in this case it is clear that the Board's judgment was not wholly unfettered by the thought that this Court had approved the regulation in *Murphy Oil Co. vs. Burnet* (1932), 287 U. S. 299, 77 L. Ed. 318, 53 S. Ct. 161 (R. 49).

See also the same reasoning in *Grace M. Barnett* (1939), 39 B. T. A. 864, which is the fountainhead and practically sole precedent for the subsequent Board cases including the instant ones. Less weight is ordinarily attached to a decision of the Board where its judgment is patently not entirely independent. *Commissioner vs. Heininger* (Dec. 20, 1943), ... U. S. ..., 88 L. Ed. (Adv. Sheet No. 4) 197, 64 S. Ct. 249.